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**The American University in Cairo  
School of Global Affairs and Public Policy**

**POLICY VS. DEDUCTION: FINANCE LEASE BETWEEN FORMAL  
PROPERTY AND ECONOMIC SUBSTANCE**

**A Thesis Submitted to the  
Department of Law**

**In partial fulfillment of the requirements for  
the LL.M. Degree in International and Comparative Law**

**By  
Akram Korany**

**May 2010**

The American University in Cairo  
School of Global Affairs and Public Policy

POLICY VS. DEDUCTION: FINANCE LEASE BETWEEN FORMAL PROPERTY  
AND ECONOMIC SUBSTANCE

A Thesis Submitted by

*Akram Samy Korany*

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POLICY VS. DEDUCTION: FINANCE LEASE BETWEEN FORMAL PROPERTY  
AND ECONOMIC SUBSTANCE

Akram Samy Korany

Supervised by Professor Hani Sayed

ABSTRACT

Is finance lease a financial instrument or property contract? This is the question that has been recently debated among the policy makers and practitioners in the Egyptian Leasing market within the discussions about the amendments of the Egyptian Leasing Law. Instead of the formal approach of the recent law, the suggested amendment debatably heads the economic reality of the transaction approach on the basis of it is more adequate to the substance of finance lease. This thesis critically examines the two approaches through representing the recent formal approach of Egyptian law, and the American approach of finance lease as an example of the economic reality of the transaction approach. This thesis argues that both approaches are formalistic in the sense they look to some labels to attach to them rights and liabilities as a matter of logical deduction. Furthermore, this thesis argues that this question is a policy question that its answer will affect the bargaining powers of parties and the architect of jural relationships among the parties of the transaction.

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## I. Introduction

In the recent discussions about the purported amendments of the Egyptian Leasing Law, there has been a debate among the practitioners and policymakers whether to apply the economic reality of the transaction, instead of the formal approach of the current law, as a criterion to redistribute the rights, privileges, and powers among parties.<sup>1</sup> According to this controversy, the finance lease law should reflect the considerations of the economic reality of the transaction or should it focus on the formal title as an indication to the distributions of rights and liabilities among the parties of the transaction?

The reason of this controversy, one can argue, is that finance lease contains two elements, one is the financial element and the second is the legal form. Based on those elements, legal systems use either one of two approaches to determine the legal nature of finance lease. The first approach considers the substance of the transaction. Based on the so-called economic reality, some countries grant the lessee what is called economic ownership.<sup>2</sup> Since the lessee has control over the leased assets, and bears all the risks of that use, the lessee has the so called economic ownership.<sup>3</sup> On the other hand, many countries have adopted another approach whereby the formality of ownership is the determinative factor. “[Such an approach] accepts legal form as determinative ownership, with special rules covering specific abuses.”<sup>4</sup>

The choice between the two approaches has many practical implications, particularly in situations where there are disagreements between lessor and lessee on the distributions and allocation of unforeseen costs, or the use of some rights and privileges

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<sup>1</sup> The author was a member of these discussions and holds unofficial records and minutes of the discussions about the purported amendments.

<sup>2</sup> WILLIAM W. PARK, *Tax Characterization of International Leases: The Contours of Ownership*, 67 Cornell L. Rev. 105, 1981-82. (Hereunder referred a Park *The Contours of ownership*.)

<sup>3</sup> *Id.*

<sup>4</sup> *Id.* at 115, *France is one of those counties that adopts the approach of formality.*

associated with ownership. To illustrate this controversy, I present a hypothetical case to illustrate in concrete terms some of these practical implications.

Therefore, part A will illustrate this case, while parts B and C will present respectively the two approaches to decide this case. Eventually, part D shows the fallacious in both approaches and addresses the right question.

#### **A. Hypothetical Case:**

Assume that A is a contractor and needs to buy a bulldozer from a German supplier. In order to finance the purchase of such bulldozer, A chooses to sign a finance lease contract. After negotiating with the supplier and selecting the bulldozer, A negotiates the lease terms with the financing company C. A and C negotiate the terms of the lease indicating that C will fund up to 90% of the purchase price of such a bulldozer and the lease term will cover 75% of the useful life of the bulldozer. In addition, at the end of the lease term, A has the option of purchasing the bulldozer at a nominal price. After reaching agreement, C imports the equipment at the expense of A, the lessee. According to the finance lease terms, the supplier will deliver the bulldozer to C who eventually will control it and bear all the risks and award the benefits of the residual value. Here, three main questions will shape the arguments of each approach and the argument this thesis raises.

First, should tax credits be allocated to the lessee or the lessor? In other words, for the purpose of tax treatment, should the lessor or the lessee add the leased assets in their balance sheets, and thus which one of them should depreciate the assets and deduct such depreciation, as tax credit, from tax liabilities? Second, as the lessee selects the leased assets, selects the supplier and the finance institution which will finance such leased assets through finance lease, should the lessee have a direct legal relation vis-à-vis the supplier and thus may lessee may directly claim the warranty and representation from the supplier? Third, should the lessor or the lessee bear the sales taxes, customs and duties and the like? For example, in a country imposes customs on the imported goods , should the lessor bear the such customs duties because only the lessor is the holder of the legal

title? Or should the lessee bear such risk because these goods are imported for the use and benefit of the lessee and the lessor acts merely as a finance conduit?

Two approaches have attempted to answer these questions though both have posed the wrong question. Based on who the owner is of this asset, each of the approaches answers these questions from a different angle.

### **B. Legal Form**

As a first approach, some legal systems regard the legal form as the determinative factor in finance lease.<sup>5</sup> Formal ownership is the basis for the distribution of rights and liabilities of parties. Based on this understanding of finance lease, the court will most likely look for the holder of the legal title and thus will respond that the finance lessor is the true owner. As logical deduction, the owner has all the rights and liabilities as a matter of course in the absence of an explicit rule. Accordingly, the lessor may add the assets to its balance sheet and depreciate them irrespective of the economic reality which is that the lessor acts merely as the financial conduit. In addition, the lessor will be liable of customs and other taxes associated with the formal ownership. For this approach, any benefits or liabilities are attached to the title as logical deduction from the general concept of ownership.

Egyptian law is an example of this approach that adopts legal form as a determinative of ownership.<sup>6</sup> Chapter II addresses the approach of Egyptian Law. Following the legal form approach, Egyptian Law, for example, grants the lessor the right to add the leased assets to its balance sheet and depreciate them.<sup>7</sup>

### **C. Economic Substance**

Unlike the legal form approach, the economic reality of the transaction approach looks for the true owner from a different angle. Based on the so-called economic reality of the transaction, some countries grant the lessee what is called *economic ownership*.

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<sup>5</sup> E.g French law *see id* at 115-18.

<sup>6</sup> Law no. 95 of year 1995 articles 24 and 25. ( Hereinafter referred as Egyptian Leasing Law)

<sup>7</sup> *Id* Egyptian Leasing Law art. 24.

Since the lessee has *control* over the leased assets, and bears all the risks of that use, the lessee has the so called economic ownership. Accordingly, the true owner, for tax purposes, is the one who bears all the risks and is awarded all the benefits from residual value. Therefore, the finance lessee, according to this approach, is the true owner and thus is entitled to the depreciation and any tax credits.

Like the legal form approach, the economic reality of the transaction approach identifies the “true” owner of the leased asset as the only question to be studied. For this approach the legal form is not the determinative factor, but it is the so called economic reality of the transaction. Therefore, in order to determine the “true” owner that enjoys the tax credits, the court will approach this issue from another angle which is economic reality of the transaction test. Who in reality does benefit from the residual value of the leased assets? Who does bear the risk of leased assets? Who has control over the leased assets?

This artificial distinction between the legal and non-legal concepts of property would be a new type of conceptualization in the Egyptian legal context whereby legal texts or judicial reasoning use new terms and link them with consequences to get around the rigidity and formality of so-called formal ownership. For instance, the lessee under finance lease has the *economic ownership* and thus is entitled to the depreciation of the leased assets instead of the legal owner.<sup>8</sup> As these terms may suggest, some court decisions in the US have considered the lessee the “true” owner vis-à-vis the legal owner or “lessor.”<sup>9</sup> That is to say, the courts tend to deal with the term “ownership” as a “thing” that can be divided vis-à-vis some laws into formal ownership and economic ownership.<sup>10</sup> The determinative aspect for them in such a case is *economic reality*.<sup>11</sup>

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<sup>8</sup> Park, *The Contours of ownership*, *Supra* note 2 at 115.

<sup>9</sup> *Da Rocha v. Macomber*, 330 Mass. 611, 116 N.E.2d 139-40, *Carlson v. Giacchetti*, 35 Mass. App. Ct. 57, 616 N.E. 2d 812.

<sup>10</sup> *Compa*, FELIX COHEN, *Transcendental Nonsense and Functional Approach*, 15 Colum. L. Rev. 810. 1915. (COHEN, *Transcendental Nonsense and Functional Approach*)

<sup>11</sup> Park, *The Contours of ownership*, *Supra* note 2 at 121-22.

The United States and other legal systems use this approach to protect the integrity of their tax systems.<sup>12</sup> Professor Park describes this approach as a way “to protect the integrity of the tax systems.”<sup>13</sup> In so doing, some countries have adopted the approach of *economic ownership* as a determinative factor as opposed to *formal ownership*:

To protect the integrity of their tax systems, many nations have rejected the *imaginary world* in which *labels* are legally determinative. Instead, these countries frequently allocate tax consequences in accordance with the *economic substance* of the transactions.<sup>14</sup>

#### **D. The Right Question:**

Both approaches ask who the owner is. For the legal form approach, the question is who the holder of the title is. On the other hand, the economic reality approach questions who the bearer of economic risks is. Such language obfuscates the correct understanding of legal relationships. It is a new conception that is being formulated in order to solve cases under the alleged umbrella of logical deduction. Economic ownership as such is not itself the determinative factor, nor is it the economic reality of the transaction which is the basis of such reasoning. Likewise, it is not the formality of the ownership which is the determinative factor nor is it the legal title. It is a form of a *vicious circle* of reasoning.<sup>15</sup> That is to say, assuming that the owner (formal/economic) pays the tax because she is the owner is “[...] assum[ing] what it needs to be decided.”<sup>16</sup> Fallacious as it seems, such arguments add nothing to our legal thinking. They affect the economic benefits of the parties. Terms like *title*, *economic reality*, *economic ownership*, or *control* are *something* the legislatures or courts use to redistribute the economic

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<sup>12</sup>Park, *The Contours of ownership*, *Supra* note 2 at 121-24. For Instance, German Tax Law has adopted this approach of *economic ownership* to allocate the benefits of assets depreciations to the *lessee* as economic owner.

<sup>13</sup> Park, *The Contours of ownership*, *Supra* note 2 at 115.

<sup>14</sup> Park, *The Contours of ownership*, *Supra* note 2 at 105.

<sup>15</sup> COHEN, *Transcendental Nonsense and Functional Approach*, *Supra* note 10 at 814.

<sup>16</sup> JOSEPH WILLIAM SINGER, *The Reliance Interest in Property*, 40 Stan. L. Rev. 641 1987-1988. (Hereinafter referred as Singer, Reliance.)

bargaining powers among the parties.<sup>17</sup> Again, courts and legislatures apply the language of logic as a link between some artificial terms to which they attach some legal consequence.<sup>18</sup>

Chapter I addresses the Egyptian approach of legal form. In this chapter, one realizes that the Egyptian Leasing<sup>19</sup> ignores the economic and financial factors of finance lease. Two problems, one can argue, face the Egyptian law maker: firstly, the rigid concept of the ownership, and secondly, the false connotation that the owner has as a logical deduction, all the rights, in a broad meaning of the word.

Chapter II, on the other hand, addresses the U.S law as an example of economic ownership under finance lease. This approach rightly realizes the economic reality of finance lease as a financial instrument. For this approach, the finance lease is a mere financial conduit between the supplier of goods and the lessee as an ultimate purchaser of the goods. This approach has ample advantages. However, it confuses the finance lease with different kinds of contracts. As a result, this approach, despite its flexibility, exposes the parties of the finance lease to unpredictability and uncertainty.

Chapter III presents Professor Hohfeld's analytical system to define finance lease through the jural relationships the finance lease creates within underlying policies. As result, one can distinguish between the finance lease and different kinds of contracts through reducing the different transactions to the lowest terms of the eight fundamental terms of the Hohfeldian system.

To conclude this thesis, one recommends reform of the Egyptian Leasing law to realize the financial and economic factors of finance lease without using the artificial labels of economic ownership that result only in confusion and arbitrary treatment.

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<sup>17</sup> ROBERT L. HALE, *Coercion and Distribution in A Supposedly Non-coercive State*, 38 POLITICAL SCIENCE QUARTERLY 470 (1923) (Hereinafter referred as Hale, Coercion).

<sup>18</sup> *Guy v. Donald* 203 U.S. 399, 406, in this case the renown justice Holmes says "As long as the matter to be considered is debated in artificial terms there is danger of being led by a technical definition to apply a certain name, and then to deduce consequences which have no relation to the grounds on which the name was applied."

<sup>19</sup> Law no. 95 of the year 1995 amended by Law no. 16 of year 2001.

## II. The Formal Approach: Case of Egypt

The central point in finance lease is the concept of property. Although the Egyptian Leasing Law does not explicitly define the property, it is, as I argue, understandable from the outset of the law that Egyptian Leasing Law follows the formal concept of property as a determinative factor in the following two senses. It is formal in the strict sense of the term in as much as it gives the possession of the formal title (e.g. proof of registration at traffic authority, real estate registry, or leasing registry) the deciding weight in determining the allocation of property rights. It is formal in the more expansive and conceptual sense in as much as it presumes that rights, powers and privileges of the owner are known a priori, and can be deduced logically from the concepts of property and ownership. In other words, Egyptian law follows the assumption that the legal owner has absolute and “ultimate control over the disposition of a thing or a set of resources.”<sup>20</sup> Fallacious as it seems, the question posed by the Egyptian lawmaker is: who is the legal owner? Having answered this question, one then erroneously assumes that this owner has systematically all rights and liabilities of such a thing. The concept of property is thus considered to be merely a relationship between the owner and a thing. Singer correctly observes in his commentary work about the concept of property concept in US law that:

[P]hrasing the problem as "identifying the owner" is fundamentally wrong. It is simply not the right question. To assume that we can know who property owners are, and to assume that once we have identified them their rights follow as a matter of course, is to assume what needs to be decided.<sup>21</sup>

To establish the relationship between finance lease and the classical concept of property, part A of this chapter analyzes the finance lease under Egyptian Law no. 95 of 1995 amended by the law no. 16 of 2001. It will present the complex, but artificial treatment by which the Egyptian lawmaker approaches the subject of finance lease. The

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<sup>20</sup> SINGER, *Reliance, Supra* note 16 at 637.

<sup>21</sup> SINGER, *Reliance, Supra* note 16 at 641.

vacuum in Egyptian law results in confusion regarding the characterization of finance lease as being a lease or a sales contract.

Part B addresses Egyptian legal thought on property. In this part, one can argue that Egyptian legal thought can be described as being mostly formalistic in the sense of its being a rigid and absolutistic approach to conceptualizing property. This part will merely deal with the contribution of Professor Al Sanhuri, the renowned scholar and the father of Egyptian modern legal thought, concerning property law.

Part C challenges this approach on the basis that formal ownership is not the determinative factor in finance lease. The argument raised here is fundamental. The controversy about property is illusive; the correct question should focus on the underlying policy and the corresponding set of legal relationships. Therefore, this part addresses two main criticisms to the formal approach; it is arbitrary in the sense that it presumes solving the underlying policy through identifying the holder of the formal title. Furthermore, it is formalistic in the sense that it presumes that once it identifies the formal owner (holder of the title) all rights, powers, privileges, and liabilities would follow such owner as a logical deduction from the concept of formal property.

Part D concludes Egyptian Leasing Law depending on the thinking of Egyptian law about property affected the realization of the mere nature of finance lease as a financial instrument. Thus, this law entails vacuum in its architect that exposes the two parties to unpredicted risks. In addition, this approach is formalistic in the sense that it depends mere on identifying the owner and then attaches to such owner all the rights and liabilities without any further considerations.

**A. Formal Ownership As The Distinctive Feature of Egyptian Leasing Law:**

The Egyptian lawmaker enacted Finance Lease Law no. 95 of 1995.<sup>22</sup> Finance lease as a contemporary financial instrument has developed tremendously in the global market.<sup>23</sup> Often, finance lease will provide up to 100% of the finances necessary to purchase equipment and real estate required for business purposes.<sup>24</sup> Finance lease also provides a non-cancelable finance period.<sup>25</sup> Due to the relationship between finance lease and the business purposes required for the financing, finance lease provides working capital to the market that in many cases enables an increase in productivity and enhancement of economic development.<sup>26</sup> However, the Egyptian lawmaker understands finance lease as a sub – category of other ownership-related contracts.<sup>27</sup>

In order to portray the approach of Egyptian law, this part presents the definition of finance lease under Egyptian law. It will then argue that Egyptian Law is not capable of fully covering the legal relationship between lessor and lessee in particular regarding economic reality. Thus, one can conclude that the law suffers from a serious vacuum that exposes the lessor and lessee to potential risks and poses constraints for characterizing the relationship between lessor and lessee.

**1. Definition of Finance Lease:**

Similar to the formal approach, the Egyptian Leasing Law focuses on formal ownership in portraying finance lease. Although, it does not provide an explicit definition

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<sup>22</sup> QADRI ABDEL FADAH, *Qanaun Al Ta'jeer El Tamwely Raqam 95 sanat 1995 Mau<sup>c</sup> dal Baqanun Raqam 16 sanat 2001, Drasa Moqarana* (Finance Leasing Law no, 95 of year 1995 amended by law 16 of year 2001 and its executive regulation, A Comparative Study,) 33-37 (2005) (hereinafter referred as Abdel Fadah, *Qqnaun Al Ta'jeer El Tamwelay*

<sup>23</sup> *Id.*

<sup>24</sup> STUART GLASS, *The Principles, in Finance Lease* 30 ( Tom Clark ed. , 2 ed. 1990).

<sup>25</sup> *Id* at 31.

<sup>26</sup> *Id* at 32.

<sup>27</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay, Supra* note 22 at 40.

for finance lease, the Egyptian law adopts three illustrations of the finance lease relationships:

**(1) Tripartite Relationships:**<sup>28</sup>

The first image of finance lease the Egyptian law adopts is the tripartite relationship whereby the lessor leases to the lessee an asset that he received from a supplier, manufacturer or contractor.<sup>29</sup> Needless to say, such a relationship includes a sale relationship between the supplier and the lessor. Conversely, the lessee has no legal relationship vis-à-vis the supplier, except that the supplier has to deliver the leased asset to the lessee. In return he will receive delivery minutes from the lessee showing that the lessee has no objection and thus accepts the asset.<sup>30</sup> In addition, the lessee can “negotiate directly with the supplier or the contractor concerning the specifications of the property necessary for his project or the method of making or establishing it.”<sup>31</sup>

This first representation obscures, rather than emphasizes, the economic substance of finance lease. The law ignores the reality that the lessor is a mere financier, and that instead the lessee, selects the assets, the supplier, and elects the financing lease as a mechanism of finance.<sup>32</sup> Instead, the legislator of the Finance Lease Law has chosen the analogy of the classical tenant contract and applied it to the finance lease.<sup>33</sup>

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<sup>28</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 44.

<sup>29</sup> Egyptian Leasing Law no. 95 of year 1995, art 2-1, Abdel Fadah, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 45.

<sup>30</sup> Egyptian Leasing Law no. 95 of year 1995, art. 8, Abdel Fadah, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 44-45.

<sup>31</sup> Egyptian Leasing Law no. 95 of year 1995, art. 7, Abdel Fadah, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 44-45 (2005).

<sup>32</sup> CHARLES W. MOONEY, JR, *Personal Property Leasing: A Challenge*, 36 Bus. Law. 1605 1980- 1981 “ Leasing companies which are essentially suppliers of monay typically do not maintain inventories of equipment. The actual supplier is a distributor or manufacturer which has dealt directly with the lessee. Having chosen the equipment the lessee may elect to lease it from the leasing company as financing mechanism.”

<sup>33</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 77-78.

**(2) Bilateral Relationships:**

In the second and third images, the law limits the finance lease relationship to a relationship between lessor and a lessee. According to articles 2.3 and 2.4 of the Leasing Law the finance lease can be:

- ii- All contracts by virtue of which the lessor is committed to lease to the lessee realties or installations owned by the lessor or established at his expense with the aim of leasing them to the lessee...
- iii- All contracts by virtue of which the lessor is committed to lease to the lessee a property under financial lease if the *ownership* of this property has devolved to the lessor from the lessee.<sup>34</sup> [Free translation by author]

In both images the law treats the lessor as mere owner and the lessee is a mere user analogously to the classical tenant contract. However, the law gives the purchase option to the lessee at the end of the leasing period.<sup>35</sup>

From the outset of these images, professor Qadri defines the finance lease under Egyptian law as follows:

According to [the images], a finance lease is the transaction related to financing capital equipment from the lessor not in purpose to own it or to transfer the ownership to the lessee, instead it aims at providing the use of such equipment to the lessee against the rentals without forcing the lessee to purchase it at the end of lease.<sup>36</sup> [Free translation by the author.]

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<sup>34</sup> Egyptian Leasing Law, *Supra* note 6 art. 2-3.

<sup>35</sup> Egyptian Leasing Law, *Supra* note 6 art. 5. ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 77-78.

<sup>36</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 38.

This definition envisages the finance lease as the relationship between owner - the financial company - and user whereby the latter can use capital equipment by the former.

## **2. The Implication Of The Definition On Accounting Standards And Tax Treatment**

The emphasis the legislative definition makes on the relationship between owner and user affects two major parts of the law; the accounting standards and tax treatment.

### **a) Accounting Standards**

To distinguish the finance lease from other contracts, especially installment sales and operating leases, the law adopts a distinctive accounting categorization whereby the law requires the incorporation of a purchase option with an encouraging price along with the fulfillment of any of the two requirements:

- a- The contract covers 75% or more of the useful life of the equipment; or
- b- The current value of the contract constitutes 90% or more of the market value of the leased asset.<sup>37</sup>

### **b) Tax Treatment:**

Again, the law focuses on the relationship between the owner and the user in order to define the tax relationship between lessor and lessee. The lessor as legal owner can add the leased asset to its balance sheet and depreciate the assets accordingly.<sup>38</sup> The lessee, on the other hand, deducts the monthly installments of the lease contract as expenses and the leased assets will not appear on the balance sheet of the lessee.<sup>39</sup> Although such a tax treatment gives incentives to both lessee and lessor, it ignores the

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<sup>37</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 135-137.

<sup>38</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 140-142.

<sup>39</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 140-142.

reality of finance lease as a financial instrument for the lessee to purchase the leased assets through the lease arrangement.<sup>40</sup>

In this context, characterizing the relationship between the lessee and the lessor is vital. The following section, therefore, will discuss the characterization of the relationship under finance lease.

### **3. The Consequences Of The Ambiguity Of The Definition**

Additional to the effects of the legislative definition on the accounting standards and tax treatment, the ambiguity of the legislative definition results in overlap between different transactional relationships. It further results in vacuum in the law regarding warranties or the relationship between the supplier and the lessee.

#### **a) Finance lease v. personal property lease (tenant contract):**

Egyptian law characterizes, one argues, the finance lease as a classical tenancy contract. In doing so, the law defines the relationship between the owner-lessor and user-lessee.<sup>41</sup> The Lessor as a legal owner transfers the right of use to the lessee. Although this image of finance lease gives the lessor a security in case of default of the lessee and gives the lessor the priority over the lessee's creditors in bankruptcy,<sup>42</sup> this image ignores the purely financial intention of the lease, and while granting certain advantages also exposes the leasing company to the risks attached to the ownership.<sup>43</sup> Such risks entail the warranties, representations, and any other risks that are attached to the ownership vis-à-vis the lessee or vis-à-vis a third party.

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<sup>40</sup> MOONEY, *Personal Property Leasing*, *Supra* note 32 at 1605. PARK, *The Contours of ownership*, *supra* note 2 at 1607.

<sup>41</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 68-69.

<sup>42</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 68-69.

<sup>43</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 68-69.

## b) Warranties:

Typically, the lessor is a financial institution. However, being the owner of the leased assets, the lessor, according to Egyptian Civil Code,<sup>44</sup> guarantees for invisible defects, the maintenance and the like. However, this image is unrealistic. Indeed, the lessee elects the finance lease as financing instrument to fund the purchase and use of capital equipment.<sup>45</sup> The lessee selects the leased assets, the supplier, the manufacturer, and may negotiate the price.<sup>46</sup> Conversely, the law deals with this reality as irrelevant and characterizes the finance lease as a relationship between owner and lessee. This image is problematic to both the lessor and lessee. For the lessor, this scenario exposes the lessor to the risks of securing the condition of the leased asset that the lessor does not select or know about.<sup>47</sup> Furthermore, this understanding exposes the lessor to the risk of maintenance.<sup>48</sup> Acting as a mere financial institution, the lessor will typically shift all these risks to the lessee by means of an artificial contractual arrangement.<sup>49</sup>

For the lessee, this scenario does not provide any safeguards. On the contrary, the lessee is not entitled to claim the warranties and representations directly from the supplier, since the law does not recognize any legal relationship between the lessee and the supplier.<sup>50</sup> In addition, practice shows that typically by contract the lessee waives any claims regarding the warranties and representations vis-à-vis the lessor, thus leaving the lessee without any safeguards.<sup>51</sup>

To exemplify, assume B, the lessee, wants to purchase digging equipment from C - the supplier. But B does not have the capital for such equipment to purchase itself. B seeks finance leasing as an alternative means of financing through A- the finance leasing

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<sup>44</sup> CODE CIVIL [ C. CIV.] art. 567 (Egypt)

<sup>45</sup> MOONEY, *Personal Property Leasing*, *Supra* note 32 at 1605-10.

<sup>46</sup> Egyptian Finance Leasing Law art 3.

<sup>47</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 68-69.

<sup>48</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 68-69.

<sup>49</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 68-69.

<sup>50</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 68-69.

<sup>51</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 68-69.

company. Therefore, B selected the equipment, supplier and the financier. Furthermore, B negotiated the price and determined the technical description of such equipment. However, it is for the purpose of legal arrangement that A as lessor has to purchase such equipment directly from C for the interest of B. A and C sign a sales agreement without having directly negotiated such agreement. Then A transfers the right to use the equipment to B and retains the title through a finance lease contract. In legal terms, though formalistic, B has no contractual relationship with C. Yet, B is the actual user of the equipment provided by C. In this case, the question of who is entitled to the warranties arises. The Egyptian leasing law has not answered this question.<sup>52</sup> In the absence of a specific rule, the general rule of sales contracts in Civil Law applies. Therefore, the purchaser, who is the lessor, is the only one who is entitled to the warranties and representations. The lessee, on the other hand, has no right vis-à-vis the supplier regarding the warranties and representations. This unrealistic situation creates constraints for both the lessee and the lessor. The lessor, who is typically a mere financier, does not have any interest in the leased assets and thus it can not guarantee the soundness and fitness of the leased assets, neither can the lessor present any warranties or representations to the lessee.<sup>53</sup> Conversely, the lessee, the one who selects the leased asset, the supplier, the financing company and the financial instrument, is very interested in the soundness and good condition of the leased assets, and thus the warranties and representations are vital for the lessee. Therefore, typically the finance lease contract entails a waiver clause whereby the lessee waives any claim against the lessor regarding the representations and warranties.<sup>54</sup> On the other hand, the lessor gives the right to the lessee to claim such warranties and representation directly from the supplier.<sup>55</sup> To mitigate any risk of losing the title as security, the lessor explicitly prevents the lessee from claiming the cancellation of the sales contract in case of supplier failure or default in any of its obligation towards the lessor.<sup>56</sup> Therefore, the lessee bears all the risks of

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<sup>52</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 77-78.

<sup>53</sup> MOONEY, *Personal Property Leasing*, *Supra* note 32 at 1605.

<sup>54</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 77-78.

<sup>55</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 77-78.

<sup>56</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 77-78

selecting the supplier and leased assets without having any way to cancel the contract with the supplier in case of a breach of contract by that supplier with the lessor.<sup>57</sup>

**c) Ownership risks vis-à-vis third parties:**

The law adopts ownership as a characteristic feature to distinguish finance lease from other financial instruments, such as loan agreements.<sup>58</sup> Therefore, the formal ownership is the distinctive feature the lawmaker adopts in defining finance leases. However, this exposes the lessor to unpredictable risks that are by law attached to ownership in the absence of otherwise explicit rules. Customs, traffic, or tax liabilities are examples of such risks. Therefore, the finance lease contract usually includes a condition that shifts all and any such potential risks the lessor may incur resulting from him being the owner onto the lessee.<sup>59</sup>

**d) Lease disguises sale:**

If the lessee is granted a purchase option at the end of the term of the lease contract, controversy about the legal nature of such contract arises; is it a “true lease” or “conditioned sale disguised as lease”?<sup>60</sup> Coogan summarizes the reality of the transaction as a reason for this controversy stating that:

[The lease parties were] interested in creating an equipment leasing device for use by prospective lessees . . . who desire the use of capital goods for which they cannot afford to pay cash outright but which a financing lessor in another Contracting State is willing to furnish if given at least minimal protection that he can regain possession if payment is not made.<sup>61</sup>

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<sup>57</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 44.

<sup>58</sup> See loan definition, ROSS CRANSTON, *Principles Of Banking Law*, 129 2d. 2002.

<sup>59</sup> ABDEL FADAH, *Qqnaun Al Ta'jeer El Tamwelay*, *Supra* note 22 at 68-69.

<sup>60</sup> See for this controversy COOGAN, *Is There A Difference Between A Long-Term Lease And An Installment Sale of Personal Property*, 56 N.Y.U. L. Rev. 1036, 1981.

<sup>61</sup> COOGAN, *Is There A Difference Between A Long-Term Lease And An Installment Sale of Personal Property*, 56 N.Y.U. L. Rev. 1036, 1981.

Therefore, the distinguishing line between lease and sale is abolished in the case where the ownership is recognized as mere security to the lessor in case of default.<sup>62</sup> The ownership, therefore, secures the lessor from the default of the lessee by giving the lessor the right to repossess the leased asset, especially in the case of bankruptcy.<sup>63</sup> However, Al-Sanhuri considers the purchase option in the lease contract with a nominal price a conditioned sale according to article 430 of Civil Code.<sup>64</sup> Thus, for Al-Sanhuri the lease is a scam that disguises a regular sale transaction.<sup>65</sup> Based on Article 430 of the Civil Law,<sup>66</sup> the consequences are twofold:

First, the ownership is transferred to the lessee on the condition of payment of the installments, and thus the lessee can dispose of the leased asset.

Second, in case of bankruptcy the lessor cannot repossess the leased asset nor has any priority over the lessee's other creditors.<sup>67</sup>

In response to such arguments highlighting the similarities between finance lease and conditioned sale, Coogan rightly emphasizes the importance of distinguishing between regular lease and finance lease:

Distinguishing between leases and secured transactions is important for determining remedies on default, and for other purposes as well. For example, if the hypotheticals contained a bankruptcy proceeding involving a lease, the supplier's or financier's rights as a lessor ... would have differed greatly from his rights as a secured party under a lease for security.

[It] is correct in saying that a lease and an installment sale are alike in that each is a method by which a

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<sup>62</sup> COOGAN, *Id* at 1040.

<sup>63</sup> COOGAN, *Id* at 1041.

<sup>64</sup> ABDEL RAZAQ EL SANHURI, *Al Wasid*, 149 (4<sup>th</sup> part c *qd El Ba* c *Sale Contract*) (hereinafter referred as El Sanhuri, *Al wasid*).

<sup>65</sup> *Id.*

<sup>66</sup> CODE CIVIL [ C. CIV.] art. 430/4 (Egypt) "the transaction is deemed as sale on installment contract even if the parties name it lease whereby the rental are considered installments of the price." [ Free translation by the author.]

<sup>67</sup> EL SANHURI, *Al Wasid*, *Supra* note 64 at 150 (4<sup>th</sup> part Sale).

prospective user obtains the use of equipment for which he is unable or unwilling to pay cash outright. They are unlike in that under a lease, as under all bailments, the lessee becomes the owner only by stepping out of his bailee shoes and stepping into the shoes of a purchaser, as, for example, when he obtains the right to use the equipment to the point of practical exhaustion or has the option to buy the equipment at the end of the lease term for a bargain price which no sensible person would refuse to exercise. If he is a purchaser, his equity will be built up with each payment.<sup>68</sup>

Although one can disagree with the scenario of this argument as it obfuscates correct legal thinking regarding finance lease, it rightly emphasizes the importance of distinguishing between finance lease and conditioned sale. Understanding finance lease as a regular sale exposes the lessor to credit risks in the case of the lessee's default. In addition, it contradicts the idea of finance lease and abolishes the lines between different financial instruments.

To sum up, one can argue that the ownership plays a pivotal role in Egyptian finance lease law. Following the attachment of the property label, Egyptian law portrays the finance lease as a relationship between the legal owner and the mere user of the asset. Despite the advantages of this approach, ownership poses constraints to the accurate legal thinking regarding the legal nature of finance lease. In addition, it leaves a vacuum in the present law exposing both parties to potential risks, especially lessees who typically are in weaker bargaining positions. One can question the plausibility of the Egyptian approach of basing consequences of law merely on the identification of the legal owner. The formalism the Egyptian approach to finance lease is embedded in the larger context of the Egyptian private law , especially Civil Code, and reflects its characteristics.

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<sup>68</sup> COOGAN, *Is There A Difference Between A Long-Term Lease And An Installment Sale of Personal Property*, *Supra* note 61 at 1045.

## **B. Egyptian formalistic approach of conceptualizing property (Al-Sanhuri's dual approach):**

Egyptian legal thought on property relates to political and social change. In the case of Egypt and in fact the entire Arabic region two cultures and consequently two schools of legal thought met. On the one hand, is the legal school of religious based thinking of Islamic scholars and on the other the school of secular thinking of the scholars of the ruling imperialist European nations. This conflict is evident if one looks at the division of the judicial system in Egypt at that time into national courts and mixed courts. While the former applied the rule of *Shari'a* codified in the *Murshid al-hayran*,<sup>69</sup> the latter applied positive law derived from European nations.<sup>70</sup>

### **1. Al Sanuhri and Dualism:<sup>71</sup>**

To unify the Egyptian legal systems, Al Sanhuri, the father of the Egyptian modern legal thought and the drafter of the Egyptian Civil Code, tried to bridge the gap between the secular and non-secular legal thinking when drafting the Civil Code. In so doing, "[Al-Sanhuri] emphasize[d] the discovery of the principles of legal right embedded in the *Shari'a* and the need to submit them to a kind of forced evolution so that they could become functional for contemporary contexts."<sup>72</sup> Yet, a closer study of property law under the Egyptian Civil Code will lead the careful reader to the conclusion that natural legal thought is the dominant point in Sanhuri's legal concept of property.<sup>73</sup> Professor Hill emphasizes that in the duality system used by Al-Sanhuri to bridge the gap between positive and nature legal thought, the non-secular Islamic thought has prevailed:

Although Al Sanhuri's efforts to develop a modern law suitable for modern Arab countries had as its central concern the induced evolution of rules derived

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<sup>69</sup> This was a codification of Islamic jurisprudence to govern the civil and commercial transaction made by "the most renowned scholar at the time" Mohamad Qadri Basha, see , ENID HILL, *Al Sanhuri And Islamic Law*, 3 Arab L. q. 35 1988. [ hereinafter referred as Hill, El Sanhuri]

<sup>70</sup> *Id* at 36.

<sup>71</sup> *Id* at 36.

<sup>72</sup> *Id* at 37.

<sup>73</sup> *Id* at 38.

from the corpus of the jurisprudence of Islamic jurists, he was quite specific that the revision of law must take account of present as well as historical experiences of each country. [...] This meant that in Iraq, where the *Majalla* was the basic civil law in force at the time, the new code was to be “more Islamic” than the code of Egypt where there had been a history of using French law for some fifty years.

Although at the time of its passage in 1948 there was considerable criticism that the new Civil Code of Egypt was not sufficiently Islamic, the record of revision activities (Ministry of Justice) shows the detailed, studied consideration that went into this new code and how and why various articles derived either from the letter or the spirit of the *Shari'a*.<sup>74</sup>

Under the assumption that this is an accurate description, the study of the concept of property under Islamic Law is relevant to the concept of property under Egyptian Law as conceptualized by El-Sanhuri.

## **2. The Definition of Property under Islamic Jurisprudence:**

Property is a fundamental concept in Islamic jurisprudence.<sup>75</sup> Islamic jurisprudence has many approaches when it comes to defining property.<sup>76</sup> “The clearer definition is that property is the sole, despotic and exclusive dominion of one over a thing against the universe that gives the owner the absolute right to dispose of it except otherwise it is religiously prohibited.”<sup>77</sup> Al Khafif emphasizes that within the different

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<sup>74</sup> *Id* at 38.

<sup>75</sup> ALI AL-KHAFIF, *Al Malki'at Fie Al Shari'a El Islami'a [Property in Shari'a]*, 20-51 (1<sup>st</sup> part 1969). See also MOHAMED FAHMI AL SERGANI, *El Malki'a wa Nazari'at Al Aqad [Property and Contract Theory]*, 21-32 (1<sup>st</sup> ed. 1977). See also ABDEL HAMID AL BA'ALY, *Property and Its Role in Economics*, 10- 113 (1999).

<sup>76</sup> ALI AL-KHAFIF, *Al Malki'at Fie Al Shari'a El Islami'a [Property in Shari'a]*, 20-51 (1<sup>st</sup> part 1969).

<sup>77</sup> MOHAMED FAHMI AL SERGANI, *El Malki'a wa Nazari'at Al Aqad [Property and Contract Theory]*, 21-32 (1<sup>st</sup> ed. 1977).

approaches that can be found, there are four common aspects.<sup>78</sup> The first common aspect espoused by Al Khafif relates to the metaphysics of property, or in other words the religious dimension of the concept of property whereby property is the religious description or religious permission based on which one is religiously allowed to own a *thing*.<sup>79</sup> While – according to this approach – *Allah*, God to whom be ascribed all perfection and majesty, owns everything on the earth, he has nevertheless appointed someone as the successor over such *thing*.<sup>80</sup>

The second common aspect is the imagery of property as a relationship between someone and something. Islamic jurisprudence emphasizes the objectivity of property as a relationship between someone and something. However, there is a dispute about the nature of that “something,” especially, whether incorporeal things can be the object of property or not.<sup>81</sup> Some Islamic schools limit the object of property to such corporeal things that can be physically held.<sup>82</sup> Other schools argue that incorporeal things can be the object of property, if the customs of the people at the time give value to such things, and consequently allow trading with such incorporeal things.<sup>83</sup>

The third common aspect that Al Khafif posits is the absolutism of property with some exceptions. Islamic scholars emphasize the absolute dominion of the owner over the thing that he owns and whereby he exercises exclusive rights and enjoys absolute privileges against the universe. This absolute power is only limited by exceptions found

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<sup>78</sup> ALI AL-KHAFIF, *Al Malki' ai Fie Al Shari'a El Islami'a [Property in Shari'a]*, supra note 76 at 17 (1<sup>st</sup> part 1969).

<sup>79</sup> AL-KHAFIF, *Al Malki' ai Fie Al Shari'a*, supra note 76 at 18.

<sup>80</sup> The appointment by Al Allah, God to whom be ascribed all perfection and majesty, is stated in Quaran “the Islamic holy book”, see ABDEL HAMID AL BA'ALY, *Al El Malki' ai wa Dorha Fie El Eqdisad, [Property and Its Role in Economics]*, 12 (1999).

<sup>81</sup> AL-KHAFIF, *Al Malki' ai Fie Al Shari'a*, supra note 76 at 20-51.

<sup>82</sup> Hanafi'a Scholar, property right is limited to corporeal things that can physically seen and hold, see AL-KHAFIF, *Al Malki' ai Fie Al Shari'a*, supra note 76 at 13.

<sup>83</sup> Al Maliki'a and Shafia'ia, see AL-KHAFIF, *Al Malki' ai Fie Al Shari'a*, supra note 76 at 13.

in the religious orders or others' interests.<sup>84</sup> For this school, property is an “*in rem* right.”<sup>85</sup>

The fourth and final common aspect is the formalistic property concept as such is decisive. That is to say, a property right includes the right to dispose of such property at the owners will. In other word, it is “the image of the owner as a person who has ultimate control over the disposition of a thing or a set of resources [in the absence of provisions.]”<sup>86</sup>

Hence, one can argue, that property law under Egyptian civil law is affected by the natural school of Islamic jurisprudence.

### **3. Property under Egyptian Civil Law (Al-Sanhuri's dual approach):**

Al-Sanhuri utilized the natural law thoughts and formalistic approach to define property. Property for him is a *right in rem* in the sense of a relationship between someone and *something*.<sup>87</sup> Therefore, the Egyptian Civil Code defines property as being something that “is for the owner of a *thing* only, within the limits of law, the right to use and dispose of it.”<sup>88</sup>

Obvious as it may seem, the Egyptian law utilizes the classical definition of property. It evokes the definition of Blackstone as quoted by Professor Singer:<sup>89</sup>

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<sup>84</sup> AL-KHAFIF, *Al Malki'ai Fie Al Shari'a*, *Supra* note 76 at 20-51. *See also* AL SERGANI, *El Malki'a*, *Supra* note 77 at 21-32; AL BA'ALY, HAMID AL BA'ALY, *Property and Its Role in Economics*, 10- 113 (1999).

<sup>85</sup> ALI AL-KHAFIF, *Al Malki'ai Fie Al Shari'a*, *Supra* note 76 at 20-51 ;*see also*, AL SERGANI, *El Malki'a*, *Supra* note 77 at 21-32, AL HAMID AL BA'ALY, *Property and Its Role in Economics*, 10- 113 (1999). “Right” here is used in the broad connotation that refers to all advantages whether rights, duties , privileges, immunities, and powers, *see* WESLEY NEWCOMB HOHFELD, *Some Fundamental Legal Conceptions As Applied In Judicial Reasoning*, 26 Yale L.J. 16 1913- 1914. ( *in rem* rights is a translation of Arabic term *Huquq yniya*)

<sup>86</sup> SINGER, *The Reliance*, *supra* note **Error! Bookmark not defined.** at 637.

<sup>87</sup> ABDEL RAZAQ EL SANHURI, *Al Wasid, Huq El Maliki'a [Property Right]*, 7 Part 8<sup>th</sup> [hereinafter referred as El Sanhuri, *Huq El Maliki'a*]“ *Right in rem* is a direct legal power over a thing whereby the owner has a direct control over it.” [Free translation by the author].

<sup>88</sup> CODE CIVIL [ C. CIV.] art. 802 (Egypt)

<sup>89</sup> SINGER, *The Reliance*, *supra* note 17 at 641.

Blackstone defined property as "that sole and despotic dominion which one man claims and exercises over the external things of the world, in total exclusion of the right of any other individual in the universe." We still carry in our heads an image of the "owner" as a person who has ultimate control over the disposition of a thing or a set of resources.

Professor Al-Sanhuri, in his valuable opinion, though erroneous from the realistic perspective, defines property along these lines as the fundamental *right in rem*, and thus he states:

It may be concluded from the definition of property right in the article is that that the right of owning a thing *connotes* the exclusive power of the owner *over it* and the sole right to use and dispose of it constantly within the limits of law.<sup>90</sup> [Free translation by the author]

This valuable commentary work of Professor Al Sanhuri, that Egyptian judges and lawyers even today cite, infers the following aspects of property under the Egyptian system.

The first aspect relates to the absolutism of property. This connotation brings about the classical model that understands property as a *castle*.<sup>91</sup> The owner of the thing can do whatever he pleases within the boundaries of his "castle," or in other words, the owner has an absolute advantage over the object of property within the boundaries of the law.<sup>92</sup> In the absence of such boundaries or to leave the metaphoric realm, in the absence of a rule of law, the owner has all the advantages, rights, duties, immunities, and privileges.<sup>93</sup> That is to say that the restriction of property is the exception. The absolutist element of property is also emphasized by Egyptian legal scholars and courts. Professor

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<sup>90</sup> EL SANHURI, *Al Wasid, Huq El Maliki'a*, *supra* note 87 at 7 " *Right in rem* is a direct legal power over a thing whereby the owner has a direct control over it."

<sup>91</sup> JOSEPH WILLIAM SINGER, *The Ownership And Takings Of Property: Castles, Investments, And Just Obligations*, 30 HARV. ENVTL. L. R. 314-16, 2006. [Hereinafter referred as Singer, Castle]

<sup>92</sup> *Id*

<sup>93</sup> *Id*

Mohamed Kamel Morsi states that “property is absolute as a general rule except in such cases in which the law restricts it.”<sup>94</sup> This absolutistic aspect of property is also emphasized by the Cassation Supreme Court:

In the absence of a rule of law, it is for the owner of a *thing* only, as a general rule, within the limits of law, the right to use and to dispose of the object of its property at her discretion according to article 802. This indicates that the owner has the right to choose the lessee, and to exclude such a lessee at the expiry of the tenant period, and to the owner only to use its property in the way at her discretion.<sup>95</sup>

Another important aspect of property in Egyptian law, though fallacious in the eyes of realists, is the physicality of property. For Al-Sanhuri, property is the basic right in rem.<sup>96</sup> It is a right over the thing which gives the owner the sole advantage to use it.<sup>97</sup> The right itself, so this argument goes, is incorporeal, but its object must be corporeal.<sup>98</sup> Therefore, Al-Sanhuri does not deem the patent as property in the strict meaning of the term, since the object of the right is not corporeal.<sup>99</sup>

The third aspect of property in Egyptian law is that property is a permanent right. For Al-Sanhuri the property right is attached to its object, and thus it only exists as long as the object exists.<sup>100</sup> This does not mean that a property right is not transferrable. On the contrary, it is transferrable between persons but property is attached to the thing which is the object of the transfer.<sup>101</sup> Therefore, this right, by its nature, cannot be temporary. To exemplify this, an agreement, whereby A agrees with B to be the owner

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<sup>94</sup> Morsy Pasha, *El Huquq El Ayni'a Al Asli'a*, supra note **Error! Bookmark not defined..**

<sup>95</sup> Cass. no. 2763 J.Y 56 (Egypt.)

<sup>96</sup> EL SANHURI, *Al Wasid, Huq El Maliki'a*, supra note 87 at 23.

<sup>97</sup> EL SANHURI, *Al Wasid, Huq El Maliki'a*, supra note 87 at 240.

<sup>98</sup> EL SANHURI, *Al Wasid, Huq El Maliki'a*, supra note 87 at 241.

<sup>99</sup> EL SANHURI, *Al Wasid, Huq El Maliki'a*, supra note 87 at 242.

<sup>100</sup> EL SANHURI, *Al Wasid, Huq El Maliki'a*, supra note 87 at 465-79.

<sup>101</sup> EL SANHURI, *Al Wasid, Huq El Maliki'a*, supra note 87 at 465-79.

for a period of five years and after this time the property will be transferred back to B has, according to Al-Sanhuri's understanding, to be considered as null and void.<sup>102</sup>

The valuable work of Professor Al-Sanhuri enriched Egyptian legal thinking. Nevertheless, his approach to defining property is more formalistic than realistic. Such a formalistic definition is misleading and neglects the more appropriate understanding of property as a relationship between legal persons and not merely between a person and a thing. Professor Singer attacked this approach to defining property in his commentary article on property law in the US:

Yet this image never has been more than partially correct. Much of the first-year property course in law schools is devoted to examining ways in which property interests can be shared or divided up. It is old-fashioned, misleading and unproductive to identify a single "owner" of valued resources when control of those resources has been divided by law or contract among several interested parties. It is, in fact, a form of transcendental nonsense... [P]hrasing the problem as "identifying the owner" is fundamentally wrong. It is simply not the right question. To assume that we can know who property owners are, and to assume that once we have identified them their rights follow as a matter of course, is to assume what needs to be decided.<sup>103</sup>

For the purpose of this thesis, two main critiques towards this formalistic approach shall be made. The first relates to the fallacious connotation this approach brings about, whereby identifying the owner connotes that the owner allocates all the advantages and disadvantages of the property.

The second critique concerns the physicality of the property in the form of the relationship between the owner and the thing. By ignoring the reality of property as being a legal relationship between individuals, Egyptian law prevents itself from understanding

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<sup>102</sup> EL SANHURI, *Al Wasid, Huq El Maliki'a*, *supra* note 87 at 465-79.

<sup>103</sup> SINGER, *The Reliance*, *supra* note 16 at 6 40.

property in a way that would more match the new forms property has taken in economic reality. One of these forms which is heavily affected by the classical concept of property is finance lease. Professor Singer, in U.S. law, addresses this incapability of the same classical view of property to develop with economic reality:

Property interests can be divided in various ways, including: (1) overtime (current versus future interests); (2) into co-ownership (joint tenancy, tenancy in common, partnership, corporations); (3) into leases (landlord/tenant relations); (4) into trusts (trustee/beneficiary); (5) into easements and covenants; and (6) into mortgages (mortgagor/mortgagee). Who owns the property in these cases? The landlord or the tenant? The trustee or the beneficiary? The mortgagor or the mortgagee? *The question is meaningless.* Just as the landlord, life tenant, defeasible fee owner, trustee, and fee simple owner may be "owners" of property, so may tenants, reversioners, trust beneficiaries, holders of future interests, and owners of easements. There are even cases in which it is difficult to identify *anyone* as the owner. Who owns a university? The board of trustees? The graduates? The students? When several parties share legal rights in property, any identification of a single person as the "owner" is likely to be both arbitrary and misleading. It is arbitrary because we could just as easily identify someone else as the owner. It is misleading because it denies the existence of joint interests and the need to determine the legal relations among all the persons with legally protected interests in the property. The "owner's" rights are limited by the rights of others with entitlements in the property. Identifying the owner does not tell us who these other people are or what their rights are.<sup>104</sup>

Therefore, for the following discussion it is relevant to look at how the classical approach of property affects finance lease under Egyptian law.

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<sup>104</sup> SINGER, *The Reliance*, *supra* note 16 at 640.

### *C. The Implication of Applying The Classical Concept of Property to Finance Lease:*

As it is demonstrated in part B, leasing under Egyptian law is a relationship between owner and user.<sup>105</sup> Therefore, this classical property concept has been a serious obstacle for the legislature at the time the Leasing Law was enacted. The classical approach to the concept of property, one argues, brings about two problems that the legislature faced.

The first problem originates in the image of property as a consolidated block of rights. This intuitive image of property caused the lawmaker to draft the law with the presumption that attaching the ownership to the lessor is the only thing the legislature had to do.<sup>106</sup> This assumption indicates that the lessor as the legal owner allocates all the rights as a matter of course. However, since the lessor acts as mere financier in a finance lease, the legislature had to develop an artificial architecture when drafting the law in order to balance the economic interests of the parties involved in a finance lease. In this context, the legislature had to try to circumvent the rigidity of the concept of property that the law was generally using.

The second problem is the physicality of the object of property. That is to say, it is the relationship between a person and a thing. This “thingification”<sup>107</sup> of property is in contrast to the purpose of finance leasing whereby the physical object of property is not the center of the relationships of finance lease, instead it is the bundle of rights this contract creates.<sup>108</sup> Therefore, the legislature has to artificially interpret the law such that it would reflect this reality and to circumvent the rigidity of the owner-property relationship.

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<sup>105</sup> Qadri Abdel Fadah, Finance Leasing Law no, 95 of year 1995 amended by law 16 of year 2001 and its executive regulation, a Comparative Study, 33-37 (2005).

<sup>106</sup> See the discussion about the intuitive image of property that is presented by JOAN WILLIAMS, *The Rhetoric of Property*, 83 Iowa L. Rev. 277 1997-1998.

<sup>107</sup> Cohen, *Supra* note10.

<sup>108</sup> Qadri Abdel Fadah, Finance Leasing Law no, 95 of year 1995 amended by law 16 of year 2001 and its executive regulation, a Comparative Study, 33-37 (2005).

The Egyptian legislature presumes the imagery of property as block which can be transferred from one party to another party.<sup>109</sup> This approach is formalistic, because the legislature applies the concept of property inexorably as a general term without regard to other options to which that concept can refer to if it is applied as jural relationships and a bundle of correlatives and opposites.<sup>110</sup> In this context, one can argue that it is the fallacy of circularity to logically deduce ownership or property can determine who the owner is. The question itself, as Professor Singer aptly argues, is not determinative in the case of economic relationships:<sup>111</sup>

[P]hrasing the problem as "identifying the owner" is fundamentally wrong. It is simply not the right question. To assume that we can know who property owners are, and to assume that once we have identified them their rights follow as a matter of course, is to assume what needs to be decided.

The following example illustrates the fallacy in this formalistic approach:

A medical company desires to import diagnostic equipment. This company selects a Chinese supplier as it is the cheapest one that supplies this equipment with the similar technical description. Still, the medical company does not have the working capital to import this equipment. For accounting and tax treatment, the medical company elects finance lease as mean to import this equipment. The medical company submitted a request to the finance lease company stating the financial and technical descriptions and attached to this request the supplier offer. After accepting the transaction, the finance lease paid the supplier and imported the said diagnostic equipment. The customs authority claims 20% customs duty over the lessor. The lessor paid this amount and debited it on the medical company's account. The lessee refused these costs on the basis that it is a mere user of the equipment and lessor is the formal owner that holds the title. As a counter argument, the lessor argues that although it is the holder of the title , it

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<sup>109</sup> FREDERICK SCHAUER, *Formalism*, 97 Yale L.J. 512-13 1987-1988

<sup>110</sup> *Id.* "formalism is the denial of the options the general term may connote and the trend to apply inexorably such term without regard to such other options."

<sup>111</sup> SINGER, *The Reliance*, *supra* note 16 at 641 .

imported this equipment for the interest and according to the lessee desires. In addition, the lessor acts merely as a fund provider. The lessor argues further that this equipment was released from customs through the lessee's representative that was aware of the customs duties. Finally the lessor argues that benefit of the use, residual value, and the operation of such equipment is for the lessee. The question here, who should bear the customs duties on the imported leased assets. Is the lessor who only has the title, but it does not select these leased assets, the supplier, the manufacturer or the origin of these lease assets? Or is it the lessee that benefits from the function, the residual value, and the use of it? This shows that formal approach of property concept would be illusive to attach to the title all rights, privileges, and liabilities as logical deduction from the formal concept of ownership. By nevertheless choosing this approach in principle, the Egyptian legislator exposes the lessor to unpredicted costs and weakens the lessor bargaining powers in the leasing market. It also poses constraints in the face of finance lease market. Yet, this approach adds nothing to our legal thinking. Therefore, the concept of property is not the answer. This a policy question to be addressed by the policymaker. However, assuming that the lessor is the owner and the rights will be attached to her as a matter of course, is assuming what needs to be decided.<sup>112</sup>

To conclude , the lawmaker faces two problems at the time of enactment of the Leasing Law as a result of the classical legal concept of property: Firstly that the legal form is the determinative factor to identify the owner and secondly that (the false connotation that) all rights and duties are attached to the ownership as a matter of course. Therefore, once the court has identified the owner, it is not necessary for it to decide any other questions.

#### **D. Formal Ownership Is Not The Answer**

The Egyptian lawmaker in the case of the Finance Lease Law treats the finance lease as mere property contract, and thus the law ignores the financial factor of finance

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<sup>112</sup> SINGER, *The Reliance*, *supra* note 16 at 641.

lease. This fallacy results, one argues, from the rigid concept of property in the Civil Code. Identifying the owner is not the right answer for finance lease, since the finance lessor acts merely as a financial intermediary between the supplier and lessee - ultimate purchaser. In addition, finance lease for the lessee is a mere finance instrument whereby the lessee can obtain the working capital required for its business. Ignoring these facts exposes both parties to unpredictability risks. In addition, it increases the transition costs for both parties at the time of contracting in order to predict the potential risks which may result from the vacuum in the Egyptian law. Therefore, one can question, at this point, whether it is not better for the Egyptian regulatory system of finance lease to approach the economic reality of the transaction system as underlying policy. Chapter three shows that the realization of the best function of finance lease requires full understanding of the economic reality of the transaction. However, as demonstrated in chapter three, this is not the right answer to the right question.

### III. The Economic Reality of The Transaction Approach: Case of The US

Similar to the formal approach, finance lease under the economic reality of the transaction approach is the relationship between owner holder of the title and user in the strict sense, or it is a relationship between a lessor and lessee in cases of sub-leases. To distinguish between both parties, the economic reality of the transaction approach, unlike the formal approach, considers the economic reality of the transaction as the determinative factor of the allocation of rights, powers and privileges.<sup>113</sup> This approach in particular in the US, creates the so-called “economic ownership” as a distinctive alternative to formal ownership.<sup>114</sup> While the latter is attributed to the lessor, the holder of the formal title, the former is attributed to the lessee that bears all the risks, awards substantially the benefit of the residual values, and controls the leased assets.<sup>115</sup> Based on the so called economic reality of the transaction, this approach considers the lessor as a mere financier and the lessee as the ultimate purchaser of the leased assets.<sup>116</sup> This approach, thus, logically deduces the allocation of rights, powers, and privileges to one party through identifying the true owner.<sup>117</sup> However, this approach results in an incoherent system that governs the finance lease and an overlap between different labels. Whether finance lease is a conditioned sale, a loan, a security agreement, or a “true” lease has been and remains the question for courts and scholars to answer in each case.

Although one can agree with the concept of economic reality of finance lease, one can argue that this approach is as fallacious as the purely formalistic formal approach. On the one hand, the system of economic reality is incoherent in the sense that this approach gives different answers to its question about the true owner. This approach on the other hand, is formalistic in the sense that it looks for a suitable label under which they can allocate the “ownership-block” to one party and attach to it some rights and liabilities as a logical deduction from the general term. Thus, this approach does not, one can argue, ask

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<sup>113</sup> Park, *The Contours of ownership*, *Supra note 1 at 103*.

<sup>114</sup> *Leasing Finance*, Euromony Book, 2d. edited by Tom Clark, 1990, 13

<sup>115</sup> Park, *The Contours of ownership*, *Supra note 1 at 103*.

<sup>116</sup> *De Lage Landen Financial Services INC v. Rozentsvit*, 939 A.2d 915.

<sup>117</sup> *E.g. De Lage Landen Financial Services INC v. Rozentsvit*, 939 A.2d 915.

the correct question, which is the question of what kind of legal relationships the finance lease creates within the underlying policy. This approach seeks an analogy under which they can allocate finance lease.

Part A of this chapter will address this modern US approach. It addresses the statutory definition of finance lease under Article 2a of U.C.C. and will present the distinctive features of the economic reality of finance lease. It is worth pointing out the creation of so-called “economic ownership” which this approach includes..

Part B addresses the different economic tests the courts make that result in controversy about the characterization of finance lease under this approach. This part will address the overlap between different and distinctive kinds of contracts from which courts in the US try to derive legal principles. A finance lease contract is, under case law in different states, considered as a sale, a loan, or a security interest contract. This overlap and the confusion created by it bring about diverse effects on finance lease and the parties to such contracts.

Part C presents the critique of this approach on the basis that it increases the uncertainty and unpredictability of finance lease. In addition it confuses the finance lease with different and distinctive contracts. Finally, the courts under this approach fallaciously look for who the owner is and then look for suitable labels under which they can connote some rights to the true owner. This makes this approach, one can argue, as formalistic as the Egyptian approach in the sense of using some labels as a matter of logic without presenting other underlying policies.

Part D concludes with the point that although the American approach of economic reality of finance lease results in development of the legal treatment of finance lease, it fails to present the right question as to what kind of relationships finance lease creates. The economic ownership is a formalistic label that the courts use in order to connote some rights and liabilities as a matter of course.

## **A. Economic Reality As Determinative**

Contrary to the Egyptian approach to legal form, the United States Law Article 2a of the Uniform Commercial Code (UCC) and courts focus on economic reality in defining finance lease.<sup>118</sup> Finance lease, according to this approach, is a financial instrument whereby the lessor's mere function is to finance the use and purchase of the leased assets.<sup>119</sup> Based on this understanding of finance lease, Article 2a of UCC includes a special definition for finance lease.<sup>120</sup> It further entails special features of the relationship finance lease may create.<sup>121</sup>

This section covers, therefore, the statutory definition, the special treatment of the relationship under finance lease, and the taxation definition. It concludes with the point that the U S law recognizes the financial aspect of finance lease as the only determinative factor of finance lease. For this approach, one can conclude that the finance lessor is just a conduit between the finance lessee and the supplier and manufacturer.

### **1. Statutory Definition**

Article 2a define finance lease as:

A lease with respect to which:

- (i) The lessor does not select, manufacture, or supply the goods;
- (ii) The lessor acquires the goods or the right to possession and the use of the goods in connection with the lease; and
- (iii) One of the following occurs;

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<sup>118</sup> U.C.C § 2A-103.

<sup>119</sup> De Lage Landen Financial Services INC v. Rozentsvit, 939 A.2d 915.

<sup>120</sup> U.C.C § 2A-103.

<sup>121</sup> U.C.C § 2A-103.

- A) The lessee receives a copy of the contract by which the lessor acquired the goods or the right to possession and use of the goods before signing the lease contract;
- B) The lessee's approval of the contract by which the lessor acquired the goods or the right to possession and use of the goods is a condition to effectiveness of the lease contract.<sup>122</sup>

## 2. Special Features of Finance Lease Relationship

The statutory definition addresses the financial factor of the finance lease as the determinative factor. From the outset of this definition the following feature has to be met in order for the relationship to qualify as a finance lease:

The definition of a finance lease includes three requirements. First, the leased goods cannot be selected, manufactured or supplied by the lessor. The lessor in a finance lease serves essentially as conduit to facilitate the acquisition of the goods the lessee from the supplier. The lessor's lack of initial involvement with the goods is the premise for relieving the finance lessor of liability from implied warranties.

Second, the lessor's acquisition of the goods must be "in connection with lease". The interest that the finance lessor acquires in the goods must be pursuant to the envisioned finance lease. This requirement further ensures the conduit position of a finance lessor. It tends to ensure that the lessee will look to the supplier for covenants and warranties, rather than to the lessor. Consequently, the supplier, not the finance lessor, is liable to the lessee.

The final requirement for finance lease is compliance with one of the four method designed to ensure the lessee receives advance notice of its rights against the supplier.<sup>123</sup>

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<sup>122</sup> U.C.C § 2A-103.

<sup>123</sup> JOHN HART MINAN & WILLIAM H. LAWRENCE, *The Law of Personal Property Leasing*, 2009

Although this statement summarizes the most important features of the finance lease under Article 2a, it ignores another important feature which is that it must qualify as a lease to begin with.<sup>124</sup> The lease aspect will be discussed in part B. The remaining portion of this part will discuss the other features as follows:

**a) Tripartite Relationship**

The intuitive image of finance lease under Article 2a is a tripartite agreement:

A finance lease is the product of a three party transaction. The supplier manufactures or supplies the goods pursuant to the lessee's specification, perhaps even pursuant to a purchase order, sales agreement or lease agreement between the supplier and the lessee. After the prospective finance lease is negotiated, a purchase order, sales agreement, or lease agreement is entered into by the lessor, and the lessee then enters into a lease or sublease of the goods. Due to the limited function usually performed by the lessor, the lessee looks almost entirely to the supplier for representations, covenants and warranties.<sup>125</sup>

Obvious as it seems, article 2a portrays the finance lease as tripartite relationships; the supplier, the lessee, and the lessor.

**b) Financial Instrument**

Finance lease is a mere financing instrument whereby a lessor is a conduit between a finance lessee and a supplier, or manufacturer.<sup>126</sup> Therefore, the first element of the status

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<sup>124</sup> U.C.C § 2A-103.

<sup>125</sup> U.C.C § 2A-103.

<sup>126</sup> De Landen Financial Services Inc. v. Rozentsvit, 939 A.2d 921

tory definition emphasizes that the lessor does not select or manufacture the leased good, instead, the lessor acts merely as conduit between the lessee and the supplier.<sup>127</sup> In the *De Lage* case, the court of appeal emphasizes this feature by stating that:

For the purpose of a finance lease, as defined in Article 2a of Uniform Commercial Code, the party merely financing the transaction has no control over its manufacture, is not involved in the selection of the product nor in any way makes a representation as to its quality or soundness, and, between the financier and the ultimate purchaser, it is usually the latter who selects the goods negotiates for its purchase and has control over its use.<sup>128</sup>

Consequently, Article 2a in its subsection (i) “requires the lessor to remain outside the selection, manufacture and supply of the goods; that is the rationale for releasing the lessor from most of its traditional liability.”<sup>129</sup>

This unique feature distinguishes the American approach of economic reality from the Egyptian approach of the legal form. The latter ignores the reality that the finance lessor acts merely as a financial mediator between the supplier and the ultimate purchaser, who is the lessee. Conversely, the American system recognizes this reality, and, based on that, the UCC emphasizes the importance of the lessor to not be involved in selecting the goods and the supplier.<sup>130</sup>

**c) The Acquisition of The Lessor Must Be “With Connection to The Lease”:**<sup>131</sup>

This element, as it will be demonstrated in part B, is crucial in determining the nature of the transaction. For the purpose of finance lease, the lessor’s role is limited to providing funding for acquisition of the lessee as the ultimate purchaser.<sup>132</sup> Consequently, acquisition of the lessor of the leased goods must be for the purpose of leasing them to

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<sup>127</sup> U.C.C § 2A-103.

<sup>128</sup> *De Landen Financial Services Inc. v. Rozentsvit*, 939 A.2d 921

<sup>129</sup> U.C.C§ 2A-103.

<sup>130</sup> U.C.C§ 2A-103.

<sup>131</sup> MINAN, *supra* note 123.

<sup>132</sup> *De Landen Financial Services Inc. v. Rozentsvit*, 939 A.2d 921

the finance lessee as an ultimate purchaser. Therefore, usually the lessee will have the option of purchasing the leased assets at the end of the lease term.<sup>133</sup> Thus, the lessor should not be involved in “marketing or supplying” the leased goods.<sup>134</sup> However, in determining the existence of this element is a case by case study.<sup>135</sup> In each case the court has to examine the role of the lessor in the transaction to determine whether this transaction can be qualified as a finance lease and thus the feature of the relationship between the lessor and the lessee.<sup>136</sup> This element is furthermore important in the relationship between the lessee and the supplier as the former will direct the relationship with the supplier regardless of the absence of any legal formality in terms of any contractual relationship.<sup>137</sup> However, the law does not require the separation of the supplier and finance lessor; instead, it requires that the finance lessor not get involved in the marketing and supplying process.<sup>138</sup> “A finance lease can be created even though the supplier and the lessor are affiliated [ but separate legal entities].”<sup>139</sup> Therefore, the determinative factor here is whether the acquisition of the lessor is merely for the purpose of the lease or not

#### **d) Warranties and Representation**

An additional distinctive feature of the American approach of finance lease is warranties and representation. Unlike the Egyptian approach, Article 2a bridges the gap between the lessee and the supplier and expands the relationship between the lessee and the supplier giving the lessee a direct right vis-à-vis the supplier regarding the warranties

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<sup>133</sup> U.C.C § 2A-103.

<sup>134</sup> *Cole v. Elliot Equipment Corporation*, 653 F.2d 1031, (5<sup>th</sup> Cir. 1981). See also *William Brook Foods, Inc, v. Corinnel Corp.* , 147 S.W. 3d 492. “These cases concluded that extension of the strict liabilities is unwarranted because the finance lessor did not do anything to place the equipment into the stream of commerce. The finance lessor served merely as financing conduit, and neither marketed nor supplied the equipment.” John Hart Minan & William H. Lawrence, *The Law of Personal Property Leasing*, 2009.

<sup>135</sup> U.C.C § 2A-103.

<sup>136</sup> *Cole v. Elliot Equipment Corporation*, 653 F.2d 1031, (5<sup>th</sup> Cir. 1981). See also *William Brook Foods, Inc, v. Corinnel Corp*, 147 S.W. 3d 492.

<sup>137</sup> MINAN, *supra* note 123.

<sup>138</sup> *Siemens Credit Corp. v. Newlands*, 905 F. Supp. 757, 28 U.C.C a\Rep. Serv. 2d 1256 ( N.D. Cal. 1994).

<sup>139</sup> MINAN, *supra* note 123.

and representations.<sup>140</sup> Again, Article 2a embodies the economic substance and raises it over the legal form of the transaction. Article 2a addresses the reality of the transaction through giving, by law, direct privileges to the lessee regarding the express and implied warranties and representations.<sup>141</sup> Article 2a recognizes that the lessee is the sole beneficiary of the leased goods and the ultimate purchaser of them. Therefore, the lessee is the most affected party by the warranty compliance.<sup>142</sup> Minnan and Lawrence address this privity problem stating that:

Although the reasonable expectation is for a finance lessee to look to the supplier, and not to the finance lessor for most of the implied warranties, the tripartite relationship of the parties creates a conceptual difficulty for the finance lessee to receive the protection of the supplier's warranties, whether they are express or implied. In fact, the supply contract, rather than extending implied warranties, might disclaim or modify them.

Although the finance lease is the party most directly affected by warranty compliance during the lease term, the supplier's warranties run to the finance lessor as the party with whom the supplier contracted. The finance lessee lacks privity of contract with the supplier, thus creating a legal obstacle to direct cause of action against the supplier for breach of warranty in the absence of an express assignment to the lessee of the warranties created in the supply agreement.

Article 2A addresses this privity problem in finance lease by making the finance lessee the beneficiary of all promises and warranties extended to the finance lessor in the supply contract. The provision applies to both express and implied warranties, and to warranties extended to other parties.<sup>143</sup>

As obvious as it may seem, this approach, contrary to the Egyptian approach, fills the legal privity problem that faces the finance lessee. However, to what extent can the

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<sup>140</sup> U.C.C § 2A-103.

<sup>141</sup> U.C.C§ 2A-103.

<sup>142</sup> MINAN, *supra* note 123.

<sup>143</sup> MINAN, *supra* note 123.

lessee enjoy the privilege of direct claim of warranties compliance from the supplier? And how does this affect the relationship between the lessor and lessee? Minnan and Lawrence also answer these questions:

The extension of the benefit of promises and warranties to the lessee can not be used as the basis for implying and duty or liability of the lessee under the supply contract. It also does not alter the contractual relationship between the supplier and the finance lessor.

The finance lessee does not receive all the rights under supply contract. The breach of the warranty by the supplier thus the lessee should entitle to reject the tendered goods and recover damages against the supplier. The finance lessee should not be entitled, however, to pursue the buyer's remedy to recover the purchase price.

These provisions, together with the exclusion of the implied warranty liability for the lessor, reflect the common understanding of parties to finance lease that the supplier should be liable to the lessee who is the user of goods and the finance lessor should not incur this liabilities.<sup>144</sup>

Apparently, one can argue, that Article 2a utilizes the metaphor of the "bundle of sticks"<sup>145</sup> in portraying this image of the tripartite agreement. It distributes the rights, liabilities, privileges, immunities among the parties so that the lessor does not need to shoulder unpredictable risks or to be liable for warranties of the goods the lessor never selects nor knows anything about as the court of appeals aptly states in the *De Lage* case:

For the purpose of finance lease, as defined in article 2 A of U.C.C, the party merely financing the transaction has no control over its manufacture, is not involved in the selection of the product nor in any way makes representation as to its quality or soundness, and, between the financier and the ultimate purchaser, it is usually the later who selects

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<sup>144</sup> MINAN, *supra* note123.

<sup>145</sup> Joseph William Singer, Democratic Estates: Property Law In Free And Democratic Society, 94 Cornell L. Rev. 1029-31 2008-2009.

the goods, negotiate for its purchase, and has control over its use.<sup>146</sup>

From another angle, the economic reality of the transaction does not alter the contractual relationship between the finance lessor and the supplier.<sup>147</sup> Whether it is a sale or a lease, the finance lessor still enjoys some rights, in the broad sense of the word, vis-à-vis the supplier.<sup>148</sup> It is only for the lessor to claim the cancelation of the supply contract and seek a recovery of the price.<sup>149</sup>

To sum up, the lessee has a direct right vis-à-vis the supplier for the express and implied warranties. The lessee can pursue damages in case of the supplier's failure of warranties. The lessee, however, can not pursue a recovery of the price or cancel the supply contract which will be limited to the finance lessor. This bundle of sticks metaphor matches the economic reality of finance lease. Yet, in part two, this bundle of sticks does not raise the right question concerning the finance lease and results in an overlap between different kinds of contracts.

#### **e) Non-cancellable “Hell and High Water Clause”**

It is obvious that Article 2a embodies the policy consideration of finance lease as an alternative financial instrument. In so doing, Article 2a emphasizes that the relationship between the lessor and the lessee is very separate from any relationship of the latter with third parties including the supplier.<sup>150</sup> Incorporating the “Hell and High water Clause,” Article 2a makes finance lease a non-cancellable contract from the lessee side.<sup>151</sup> In other words, the lessee's obligation of payment of the rentals is non-cancellable.<sup>152</sup> Under this clause, the lessee has no right to cease the payment of rentals under finance lease despite dissatisfaction with any of the third parties including the

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<sup>146</sup> De Landen Financial Services Inc. v. Rozentsvit, 939 A.2d 921

<sup>147</sup> MINAN, *supra* note123.

<sup>148</sup> MINAN, *supra* note123.

<sup>149</sup> MINAN, *supra* note123.

<sup>150</sup> Colorado Interstate Corp. v. CIT Group., 995 F.2d 743, 749 (10<sup>th</sup> Cir. 1993)

<sup>151</sup> U.C.C§ 2A-407.

<sup>152</sup> C&J Vantage Leasing Co. v. Hillcrest Country Club, Inc., 200 S. WL. S 681220

supplier.<sup>153</sup> Divorcing the obligation of the lessee to make the payment of rentals from any other disputes the lessee may have with third parties, regarding the use of goods, is justified as the finance lessor plays no role in selecting and manufacturing such goods.<sup>154</sup> Some courts have gone further stating that the lessee obligation is “separate from any alleged breach of duty by the lessor.”<sup>155</sup> Minnan and Lawrence aptly summarize this clause as follows:

The article 2A provision adds a special rule for finance leases. Acceptance by a finance lessee made with knowledge of non-conformity can not be revoked, because of the nonconformity. The rule is consistent with the nature of finance lease. The finance lessor acts merely as a financing conduit between the supplier of goods and the finance lessee.<sup>156</sup>

However, for this clause to be valid, Article 2A requires an acceptance from the lessee of the leased goods.<sup>157</sup> To examine the existence of the acceptance, the court has to test whether the lessee has a reasonable opportunity to inspect the goods and “a) signifies or acts in a way signifying the goods and conforming and b) the lessee fails to make an effective rejection of goods.”<sup>158</sup> Based on the existence of the acceptance of the good from the lessee, the lessee has no right with any way to revoke the lease contract and cease the payment of the rentals.

All in all, from the outset of the features of finance lease, one can argue that, contrary to the Egyptian approach, the American approach focuses on the finance element of finance lease, rather than the legal form. Based on the economic reality,

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<sup>153</sup> C&J Vantage Leasing Co. v. Hillcrest Country Club, Inc., 200 S. WL. S 681220

<sup>154</sup> Direct Capital Corp. v. New ABI Inc. , 13 Misc, 3d 1151, 822 N. Y. S. 2d 684 ( Supp. 2006) “ The finance lessor can enforce a lease irrespective of the lessee’s disputes with the supplier. The supplier was not a party to the lease agreement. Thus claims against the supplier are independent from the question of the finance lessee’s liability to the finance lessor.”

<sup>155</sup> C&J Vantage Leasing Co. v. Hillcrest Country Club, Inc., 200 S. WL. S 681220. See also Wells Fargo Bank Minnesota, N.A. v. B. C. B. U., 49 Cal. Rptr. 3d 324 (Cal. Ct. App. 2006), De Lage Landen Financial Services, Inc, v, Cricket’s Termite Contro;, Inc., 942 So. 2d 1001 (Fla. Ct. App. 2006).

<sup>156</sup> MINAN, *supra* note123.

<sup>157</sup> U.C.C § 2A-407.

<sup>158</sup> Direct Capital Corp. v. New ABI Inc. , 13 Misc, 3d 1151, 822 N. Y. S. 2d 684 ( Supp. 2006)

Article 2A addresses the lessor as a mere financing conduit between the supplier of goods and the lessee as an ultimate purchaser of the goods. Therefore, the acquisition of the lessor must be in connection with the lease in a manner that reflects no interest on the part of the lessor in marketing or supplying the goods. Consequently, the lessee, as an ultimate purchase, has a direct interest in the warranties and representations from the supplier, because the lessor acts as a mere financier, and thus the lessor can not shoulder such liability. Furthermore, Article 2A provides that the finance lessor is a mere financing conduit, and thus the lessor has a non-cancellable right vis-à-vis the lessee of having the payment of rental in due time.

### 3. Taxation Definition

To preserve the tax integrity, the IRS creates the so called economic ownership and allocates such to the lessee and an economic owner.<sup>159</sup> Based on the so called economic reality of finance lease, American law allocates the privileges of depreciation of assets to the economic owner.<sup>160</sup> Under this approach, the courts look closely at the nature of the transaction and decide who the owner for the purpose of taxation is.<sup>161</sup> In the *Lyon* case,<sup>162</sup> the Court of Appeal had to consider a lease and sale back transaction whereby the taxpayer purchased a building under construction from a bank and leased it back to the bank through a long-term finance lease. Based on the legal title, the District Court held a judgment in favor of the taxpayer as the legal owner and thus entitled the depreciation of the assets deductible from the tax to him. The Court of Appeals reversed the District Court's decision on the basis that the taxpayer, the finance lessor, is not the true owner of the building; instead, it is the bank, as the latter bears substantially all the risks, benefits and liabilities:

The United States Court of Appeals for the Eighth Circuit reversed. It held that the Commissioner correctly determined that Lyon was not the true

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<sup>159</sup> See, WILLIAM W. PARK, Tax Characterization of International Leases: The Contours of Ownership, 67 Cornell L. Rev. 1981-82.

<sup>160</sup> *Compa. Stuard, supra* note 24 at 13- 15.

<sup>161</sup> *Frank Lyon co. v. United States*, 435 U.S. 561.

<sup>162</sup> *Frank Lyon co. v. United States*, 536 F.2d 746 (8<sup>th</sup> Cir. 1976)

owner of the building and therefore was not entitled to the claimed deductions. It likened ownership for tax purposes to a "bundle of sticks" and undertook its own evaluation of the facts. It concluded, in agreement with the Government's contention, that Lyon "totes an empty bundle" of ownership sticks. It stressed the following: (a) The lease agreements circumscribed Lyon's right to profit from its investment in the building by giving Worthen the option to purchase for an amount equal to Lyon's \$ 500,000 equity plus 6% compound interest and the assumption of the unpaid balance of the New York Life mortgage.<sup>1</sup> (b) The option prices did not take into account possible appreciation of the value of the building or inflation. (c) Any award realized as a result of destruction or condemnation of the building in excess of the mortgage balance and the \$ 500,000 would be paid to Worthen and not Lyon. (d) The building rental payments during the primary term were exactly equal to the mortgage payments. (e) Worthen retained control over the ultimate disposition of the building through its various options to repurchase and to renew the lease plus its ownership of the site. (f) Worthen enjoyed all benefits and bore all burdens incident to the operation and ownership of the building so that, in the Court of Appeals' view, the only economic advantages accruing to Lyon, in the event it were considered to be the true owner of the property, were income tax savings of approximately \$ 1.5 million during the first 11 years of the arrangement. The court concluded, "In sum, the benefits, risks, and burdens which [Lyon] has incurred with respect to the Worthen building are simply too insubstantial to establish a claim to the status of owner for tax purposes. . . . The vice of the present lease is that all of [its] features have been employed in the same transaction with the cumulative effect of depriving [Lyon] of any significant ownership interest."<sup>163</sup>

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<sup>163</sup> Frank Lyon co. v. United States, 435 U.S. 569-71.

Obvious as it seems, the court answered the question of who the “true” owner of the building is. For the Court of Appeals the legal owner was just a conduit and thus it was not the true owner. In determining who the owner is, the court looked at the following:

- i- Who does bear all the risks?
- ii- Who does substantially benefit from the building?
- iii- Whether the amount of rentals during the lease term covers all the costs plus the interest.
- iv- Whether the legal owner does not have any interest in the building or upholds a reversionary interest in the building.
- v- Whether the lessee can exercise the purchase option at the end of the lease without any other consideration or with nominal consideration.

Based on these considerations, the court held that the legal owner is not the true owner, instead, the bank, as an economic owner, is the true owner for the purpose of the tax.

In conclusion, the American approach focuses substantially on economic reality, rather than the legal formality of the transaction. The finance lessor is a mere conduit between the supplier of goods and the finance lessee as an ultimate purchaser of the goods. The finance lessor does not hold any reversionary interest in the leased goods. Therefore, the American approach, based on the theory of “bundle of rights,” redistributes the rights and liabilities in a way that fits the policy justification of finance lease as an alternative of finance instruments. Yet, this treatment results in debate among the scholars and courts to determine the nature and characterizations of finance lease.

### **B. The Implication of Economic Reality of The Transaction**

Despite of the flexibility this approach may suggest, this approach has negative implications on the court reasoning that result in the following consequences:

First, in answering the question of who the true owner is, the courts created different tests resulting in different legal relationships.

Second, the courts fallaciously keep looking for analogies under which they could allocate the finance lease to attach a bundle of rights, in the broad sense of the word, and

logical deduction from this general analogy.<sup>164</sup> This approach of characterization, though fallacious reasoning, results in a struggle among the scholars and courts about which analogy it is the best to allocate the finance lease under.<sup>165</sup> The statutory definition requires the finance lease to be qualified as a “true” lease.<sup>166</sup> However, based on the bundle of rights and sticks, the courts have applied different analogies to finance lease. “The most frequently litigated ‘commercial law’ issue relating to personal property leases has been whether a purported lease is a so-called ‘true lease’ or merely a disguised secured sale or loan.”<sup>167</sup>

### **1. True Lease; Finance Lease v. Operating Lease**

The “true lease” requirement raises a conceptual difficulty to identify the nature of the transaction as to whether it is a “true” lease or a disguised sale, or security interest, or loan or the like. Some scholars argue that in order to determine whether the purported lease is a true lease, courts should economically analyze the transaction in order to check who bears the risks and benefits of residual value at the end of the lease term:

The courts must determine whether the lessor or lessee has economic risk and benefits with respect to the residual value of the equipment at the end of the lease term, if risk and benefits reside with the lessor, the transaction should be properly characterized as a [true] lease and if they reside with the lessee as a secured transaction.<sup>168</sup>

Some other scholars argue further that the courts have to determine whether “the lessee receives only the use of property for a certain period of time with an obligation to redeliver it at the expiration.”<sup>169</sup>

However, these arguments confuse the finance lease with an operating lease and remove the distinguishing line between both. By definition, an operating lease also

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<sup>164</sup> See, PARK, *The Contours of Ownership*, *supra* note 2 at ----.

<sup>165</sup> BARRY A. GRAYNOR, ET AL, *The Uniform Commercial Code Survey: Leases*, 62 Bus. Law. 1580 2006-2007.

<sup>166</sup> U.C.C. § 2A-103(2003).

<sup>167</sup> MOONEY, *Personal Property Leasing*, *supra* note 32 at 1610 1980- 1981

<sup>168</sup> LAWRENCE F. FLICK, ET AL, *Leases*, 57 Bus. Law. 1694 2001-2002.

<sup>169</sup> MOONEY, *Personal Property Leasing*, *supra* note 32 at 1612.

constitutes a true lease.<sup>170</sup> In so doing, the lessor has to retain the risks and benefits of residual value.<sup>171</sup> The lessor also has to retain the title and transfer to the lessee the use who eventually will return the leased goods to the lessor at the expiry date.<sup>172</sup> This means that the true lease test does not distinguish between operating and finance lease. However, finance lease, by definition, is a financial instrument, and thus usually the lessor transfers the risks and benefits to the finance lessee. In addition, the finance lessor does not hold any reversionary interest in the leased goods.<sup>173</sup> This means that the finance lease can not be a true lease in these terms. Therefore, the courts have been dealing with finance lease as more akin to a loan, conditioned sale, or security interest.

## **2. Retention of Title (finance lease v. security interest)**

Can you begin with a topic sentence... Since the lessor does not hold any reversionary interest in the leased goods, nor does the lessor hold any risks or benefits with connection to the residual value, some courts have held that retention of title is just a mere security.<sup>174</sup> Some courts found that giving the lessee the purchase option for no further consideration or for nominal price makes the finance lease akin to security interest.<sup>175</sup> In *Carison v. Giacchetll*, the court embodied the economic test to determine whether the purported lease is a true lease or a mere security interest:

In determining whether equipment lease is a true lease or security interest, focal point of inquiry should be straightforward economic analysis; if obligations of lessee under lease are not subject to termination be lessee, and if the lease is for full economic life of goods ( or if lessee may, without

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<sup>170</sup> JOHN P. HOWITT, *Selected Issues With Respect to Operating Leases*, 702 PLI/Comm 549. " An operating lease should constitute a "true" lease, rather than a disguised installment sale or loan and security interest.. in advising a lessor on this issue, one practical approach is to review with the extent to which it is intending to retain significant residual value risk.

<sup>171</sup> *Id.*

<sup>172</sup> *Id.*

<sup>173</sup> C&J Vantage Leasing Co. v. Hillcrest Country Club, Inc., 200 S. WL. S 681220.

<sup>174</sup> MOONEY, *Personal Property Leasing*, *supra* note 32 at 1612

<sup>175</sup> PSINET, Inc. v. Cisco Systems Capital Corp., 271 B. R. 1 (Bankr. S. D. N. Y 2001), see also Cooper v. Lyon Financial Services, Inc., 65 S. W. 3d 197).

further consideration acquire all rights in goods for full economic life of goods) then security interest is created, but if lessor retains reversionary interest in goods, then transaction is true lease.<sup>176</sup>

However, this argument is as confusing as the argument of true lease. It is confusing as it contradicts the financial factor of finance lease. The finance lessor acts merely as a financial conduit between the supplier and lessee. Therefore, the retention of the title can not be more than a form of security in the case of default. Conversely, this argument brings about the risks of the applicability of usury limits on the finance lessor.<sup>177</sup> Therefore, the finance lessor usually holds artificially some interest in the leased goods through either removing the purchase option or making the determination of the price according to the market value.<sup>178</sup>

Conversely, it is a fallacy to follow this argument, as it adds nothing to determining the legal nature of a finance lease. A finance lease is just a financial instrument and the financier lessor acts merely as a financier conduit.<sup>179</sup> Therefore, the rentals of the lessee must cover substantially the risk of residual value. Furthermore, any remaining benefit of residual value at the end of the lease will be transferred to the lessee. This is one of the most important incentives the finance lease provides.<sup>180</sup> The lessee enters into a finance lease as a financial mechanism to acquire the leased assets; preventing the lessee from the purchase option or incorporating a price equivalent to market discourages the lessee to seek the finance lease.<sup>181</sup> Therefore, this argument clouds, rather than enlightens, the right legal thinking of finance lease.

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<sup>176</sup> Carison v. Giacchetti, 35 Mass. App. Ct. 57, 616 N.E. 2d 810.

<sup>177</sup> MOONEY, *Personal Property Leasing*, supra note 32 at 1612, see also Cooper v. Lyon Financial Services, Inc., 65 S. W. 3d 197).

<sup>178</sup> Cooper v. Lyon Financial Services, Inc., 65 S. W. 3d 197).

<sup>179</sup> De Landen Financial Services Inc. v. Rozentsvit, 939 A.2d 921

<sup>180</sup> STUART GLASS, *The Principles, in Finance Lease* 13 ( Tom Clark ed. , 2 ed. 1990)

<sup>181</sup> PETER F. COOGAN, *Is There A Difference Between A Long-Term Lease And An Installment Sale of Personal Property*, 56 N.Y.U. L. Rev. 1036, 1981.

### **3. Hell and High Water (Finance lease v. Loan)**

Some courts have found that the finance lease is akin to or exactly like a loan in the sense that it imposes an absolute obligation over the lessee of the payment of rentals under the Hell and High Water Clause.<sup>182</sup> In the *De Lage* case, the court characterized the relationship between the lessor and lessee under the Hell and High Water clause as a creditor-debtor relationship.<sup>183</sup> Under loan, the lender lends an amount of money to the borrower.<sup>184</sup> Therefore, the court, in the *De Lage* case, applied the definition of loan on the finance lease with the change that the finance lessor lends the equipment instead of the money.<sup>185</sup>

However, this is a fallacious extension of the concept of loan. Loans are known as a money borrowing instrument.<sup>186</sup> In addition, the lessee, as a common practice, does not return the leased goods to the lessor. Therefore, the relationship that a loan creates is different from the one finance lease creates.

### **4. Economic Ownership (Finance lease v. Conditioned sale)**

In the final analogy, courts have tried to allocate the finance lease under the conditioned sale.<sup>187</sup> In the *Lyon case*, the court creates the so called economic ownership and thus found that the lessee is the true economic owner of the leased goods.<sup>188</sup> Based on the so-called economic reality, the court examines the economic substance of the transaction to identify who the true owner is.<sup>189</sup> For tax courts, the lease can be a conditioned sale if the court finds that the lessee bears the risks and awards of the residual

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<sup>182</sup> *De Lage Landen Financial Services, Inc. v. Rozentsvit*, 939 A. 2d 921. *Colorado Interstate Corp. v. CIT Group.*, 995 F. 2d 743, 749 (10<sup>th</sup> Cir, 1993). *C&J Vantage Leasing Co. v. Hillcrest Country Club, Inc.*, 200 S. WL S 681220. See also *Wells Fargo Bank Minnesota, N.A. v. B. C. B. U.*, 49 Cal. Rptr. 3d 324 (Cal. Ct. App. 2006).

<sup>183</sup> *De Lage Landen Financial Services, Inc. v. Rozentsvit*, 939 A. 2d 921.

<sup>184</sup> Ross Cranston, *Principles of Banking Law*, 131-33 2002.

<sup>185</sup> *De Lage Landen Financial Services, Inc. v. Rozentsvit*, 939 A. 2d 921.

<sup>186</sup> ROSS CRANSTON, *Principles Of Banking Law*, 129 2d. 2002.

<sup>187</sup> *De Rocha v. Macomber*, 330 Mass. 611, 116 N. E. 2d 139.

<sup>188</sup> *Frank Lyon Co. v. United States*, 536 F.2d 746 (8<sup>th</sup> Cir. 1976)

<sup>189</sup> *Frank Lyon Co. v. United States*, 536 F.2d 746 (8<sup>th</sup> Cir. 1976)

value of the goods.<sup>190</sup> “Asking who bears the risk and reward associated with fluctuations in residual value is a convenient way of determining whether the original has a realistic expectation of return of something substantial.”<sup>191</sup> Similar to this approach, the Bankruptcy Courts can find that the purported lease is a conditioned sale and thus dismiss the repossession claim of the lessor.<sup>192</sup>

However, changing the nature of contract of being a lease and replace it with a sale, changes the economic incentives of the parties, and endangers the finance lease interests in the transaction especially in the event of default. It further makes the result unpredictable and raises the uncertainty of the transaction.<sup>193</sup>

In conclusion, phrasing the issue as to who the owner is, and to answer such a question based on the so called economic reality, results in an overlap between the finance lease and different kinds of contracts. In addition, it abolishes the distinctive nature of finance lease as a finance instrument that takes the form of lease. Finance lease is not a true lease, and it is not a security agreement, a loan or a conditioned sale. Thus, one can wonder why the courts and scholars failed to recognize the suitable legal characterization of finance lease.

### **C. Nor It Is The Economic Ownership Is The Correct Answer**

Many scholars rightly argue the importance of keeping a distinctive line between finance lease and any other different, but distinctive contracts.<sup>194</sup> For them this transactional approach of defining and analyzing the finance lease makes the situation more complex, and confuses the finance lease with other distinctive contracts.<sup>195</sup> They

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<sup>190</sup> PARK, *The Contours of Ownership*, *supra* at 178-80.

<sup>191</sup> PARK, *The Contours of Ownership*, *supra* at 178, NEIL Z. AUERBACH, *A Transactional Approach to Lease Analysis*, 13 *Hofstra L. Rev.* 309 1984-1985.

<sup>192</sup> MOONEY, *Personal Property Leasing*, *supra* note 32 at 1612

<sup>193</sup> MOONEY, *Personal Property Leasing*, *supra* note 32 at 1612

<sup>194</sup> COOGAN, *supra* note 181 at 1057, MOONEY, *Personal Property Leasing*, *supra* note 32 at 1612, see also Cooper v. Lyon Financial Services, Inc., 65 S. W. 3d 197).

<sup>195</sup> AMELIA H. BOSS, *Panacea or Nightmare? Leases in Article 2*, 64 B.U. L. REV. 39 1984

raise two main critiques, and one can add one more. The first critique concerns the overlap the case law results in between different and distinctive kinds of transaction.<sup>196</sup> Treating finance lease as a conditioned sale contradicts the legal nature of finance lease.<sup>197</sup>

The second critique concerns the uncertainty and unpredictability that affect the leasing business. Mooney summarizes this critique in stating that:

[P]revailing case law surrounding the lease-security interest issue reveal a hodge-podge of subjective and extraneous criteria with which the courts are called upon to determine the issue. It reflects a marked failure to appreciate and consider the essential elements of leases and secured transactions in conceptual and historical context. The result is plethora of contradictory authorities yielding little outcome predictability in any given jurisdiction. The discomfort is felt in connection with negotiation, drafting, construction and litigation.<sup>198</sup>

However, none of these critiques has addressed the right reason. The problem is, one can argue, that neither the economic ownership approach nor legal form ownership approach has posed the right question about finance lease. Deciding who the owner is and then allocating the finance lease under one different contract and connoting the legal rights and duties as a logical deduction is transcendental nonsense.<sup>199</sup> It is a formalistic way of solving the issue by imposing one label after the other as a matter of logical deduction.<sup>200</sup> Both approaches ignore the right question, which is what kind of relationships finance lease creates within the underlying policies. Applying some labels to the case and deducing from them the rights and liabilities of parties is assuming what needs to be decided. In the American approach, the courts still look for who the “true” owner of the leased assets is. Based on the answer, they allocate certain rights, liabilities

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<sup>196</sup> MOONEY, *Personal Property Leasing*, *supra* note 32 at 1612, see also *Cooper v. Lyon Financial Services, Inc.*, 65 S. W. 3d 197.

<sup>197</sup> MOONEY, *Personal Property Leasing*, *supra* note 32 at 1612, see also *Cooper v. Lyon Financial Services, Inc.*, 65 S. W. 3d 197.

<sup>198</sup> MOONEY, *Personal Property Leasing*, *supra* note 32 at 1612

<sup>199</sup> Cohen, *Supra* note 17.

<sup>200</sup> Schauer, *supra* note 109 at 512-13.

and the like to that owner. Fallacious as it may appear, this approach has not answered the question of why we allocate such rights or liabilities to such a party. In other words, why should the lessee be entitled to the warranties? Why should the lessor be safe from any claim regarding the relationship between the lessee and the supplier? Like the Egyptian law, the American legal system of finance lease suffers from the formalistic way of defining the legal relationships of the so-called finance lease. Hale and other realistic scholars show that law always affects the coercive powers of parties.<sup>201</sup> This is apparent in the finance lease regulatory system under both approaches. Either economic reality or legal form approaches are in themselves policy justifications that affect the coercive powers of the parties of a finance lease.

#### **D. Conclusion**

Unlike the Egyptian approach, the American approach realizes the importance of the economic substance of the finance lease. For the American approach, the finance lease is just a conduit between the supplier of goods and the finance lessee, the ultimate purchaser. Based on that fact, the American approach extends some rights and privileges to the lessee vis-à-vis the supplier. In addition, it protects the finance lessor from guaranteeing goods the lessor does not select or manufacture. Eventually, the courts created the so-called economic ownership as a basis for allocating some rights to the lessee as a true economic owner. However, in determining the legal nature of the finance lease whether it is a true lease or not, the courts have used some analogies under which these can connote who the owner is and eventually connote the rights and duties of the parties. This approach of identifying the finance lease clouds, rather than enlightens, the right and distinctive characterization of finance lease. It further contrasts the finance lease as an instrument of finance. One reason for that, as this argument goes, is that neither the American approach, nor the Egyptian approach addresses the right question: What kind of relationship does finance lease create within the underlying policies? Such would be the suitable angle to look at the legal analysis of the question at stake.

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<sup>201</sup> Hale, *supra* note 17, OLIVER WENDELL HOLMES, *The Path of The Law*, 110 Harv. L. Rev. 991 1996-1997.

#### IV. Hohfeld and The Right Question

Putting the matter in another way, the tendency – and the fallacy – has been to treat the specific problem as if it were far less complex than it really is; and this commendable effort to treat as simple that which is really complex has, it is believed, furnished a serious obstacle to the clear understanding, the orderly statement, and the correct solution of legal problems. In short, it is submitted that the right kind of simplicity can result only from more searching and more discriminating analysis.

Wesley Newcomb Hohfeld<sup>202</sup>

This statement from the prominent professor Hohfeld summarizes the problem of the two approaches. While the Egyptian approach seeks the simple answer of the ownership issue under finance lease through the legal form of the ownership, the American approach deals with finance lease with the same simplicity through the so-called economic reality and economic ownership. Neither of the two approaches has provided a comprehensive answer and analysis to the question of ownership under finance lease. Each of the two approaches finds the answer through some analogies of other endless labels. Labels, such as legal or economic ownerships are wrong answers to wrong questions.

By answering the question who the holder of the title is, the formal approach, exemplified by Egyptian Leasing Law, results in very arbitrary consequences as it depends solely on indentifying the holder of title without examining the real jural relationships created within the underlying policy. In addition, this approach removes any reference to the policy consideration and emphasizes the answering of the question of identifying the holder of the title to attach to such holder rights, powers, liabilities and the like as matter of logical deduction.

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<sup>202</sup> WESLEY NEWCOMB HOHFELD, *Some Fundamental Legal Conceptions As Applied In Judicial Reasoning*, 26 Yale L.J. 16 1913- 1914,

Similarly, the economic reality approach, exemplified by the American legal thought, is as fallacious as the formal approach. By indentifying the true owner, this approach results in an incoherent analytical system that raises the uncertainty and unpredictability about the judicial reasoning. In addition, this approach is as purely formalistic as the formal approach as it looks for different labels and analogies under which they allocate the finance lease to presume some rights, powers and the like as a logical deduction from such general labels.

The question this thesis raises is the one Hohfeld aptly and rightly addresses and then to apply it to finance lease: what kind of jural relationships does finance lease create within the underlying policy? This chapter is divided into two parts: part A gives a brief overview of Hohfeld's analytical system of jural relationships. Through a group of eight fundamental legal concepts that are divided into a scheme of correlatives and opposites, Hohfeld contends that any label can be analyzed in a jural relationship in this scheme of correlatives and opposites.<sup>203</sup>

Part B applies this analytical system to two main relationships that finance lease creates; first the relationship between finance lessee and the supplier, and the relationship between the lessor and the lessee. In this part, one argues that after demonstrating the failure of using some labels of ownerships as determinative factors, the analytical system of relationships can be the best way to distinguish the finance lease.

### **A. Hohfeld System**

The central point of this thesis is the ownership concept under finance lease. For Hohfeld this concept denotes a group of jural relationships between social figures within the underlying policy.<sup>204</sup> Through his four categories of fundamental concepts and the scheme of correlatives and opposites he places them in, Hohfeld aptly realizes that in

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<sup>203</sup> *Id.*

<sup>204</sup> HOHFELD, *Id* , See also JOSEPH WILLIAM SINGER , *The Legal Rights Debate*, 1982 Wis. L. Rev. 987 1982.

discussing any legal concept, one has to realize as a first step the relationship such a concept may involve.<sup>205</sup>

### **Jural relationships within the scheme of fundamental concepts**

Hohfeld criticized the classical limitation of legal relationship to only right-duty relationships.<sup>206</sup> For him, this is a classical misleading characterization of legal relationships:

One of the greatest hindrances to the clear understanding, the incisive statement, and the true solution of legal problems frequently arises from the express or tacit assumption that all legal relationship may be reduced to “rights” and “duties,” and that these latter categories are therefore adequate for the purpose of analyzing even the most complex legal interests.

Therefore, for him finance lease is not a mere relation between rights and duties in the strict meaning of these concepts. Instead, he would look to the finance lease within the framework of jural relationship of correlatives and opposites under the four categories he establishes.<sup>207</sup> Under these four categories there are eight terms that are arranged in table form.<sup>208</sup>

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<sup>205</sup> HOHFELD, *supra* note 202.

<sup>206</sup> *Id.*

<sup>207</sup> HOHFELD, *Id.*, see also JOSEPH WILLIAM SINGER, *The Legal Rights Debate*, 1982 Wis. L. Rev. 990 1982..

For some other scholar there are more legal categories for jural relationships, *compa*, KOCUREK, *The Hohfeld System of Fundamental Legal Concepts*, 15 ILL. L. Rev. 24 1920.

<sup>208</sup> JOSEPH WILLIAM SINGER, *The Legal Rights Debate*, 1982 Wis. L. Rev. 986 1982, WESLEY NEWCOMB HOHFELD, *Some Fundamental Legal Conceptions As Applied In Judicial Reasoning*, 30 Yale L.J. 16 1913- 1914

### Jural Opposites

Rights	Privilege	Power	Immunity
No-right	Duty	Disability	Liability

### Jural Correlatives

Rights	Privilege	Power	Immunity
Duty	No-right	Liability	Disability

By the “opposites-schemes,” Hohfeld focuses on one party of the relationship. That is to say that, a single party has to have “one or the other but not both opposites.”<sup>209</sup> For example, the lessor under finance has a right vis-à-vis the lessee to pay the rentals or the lessor has no right; it can not be both. Similarly, the finance lessor either has a privilege to do certain acts or a duty not to do certain acts vis-à-vis the lessee or the others.<sup>210</sup> Likewise, the law or contract may give immunity to the lessor regarding the warranties and representation vis-à-vis the lessee or may make the lessor liable for such warranties, it can not be both.

On the other hand, Hohfeld aptly and rightly emphasizes the jural relationships between two parties or more through the correlatives scheme.<sup>211</sup> He addresses the solutions of legal problems through the correlatives between the parties, rather than the labels that usually lead to confusion. Through correlatives Hohfeld proposes that when the law allocates one of the above concepts to one party, the law “simultaneously creates vulnerability on the others.”<sup>212</sup> For examples, if the lessee has a right vis-à-vis the supplier regarding the compliance of warranties and representations, the law simultaneously creates a duty over the supplier vis-à-vis the lessee to comply with warranties and representations.

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<sup>209</sup> JOSEPH WILLIAM SINGER, *The Legal Rights Debate*, 1982 Wis. L. Rev. 990 1982, HOHFELD, *supra* note 202.

<sup>210</sup> JOSEPH WILLIAM SINGER, *The Legal Rights Debate*, 1982 Wis. L. Rev. 990 1982.

<sup>211</sup> HOHFELD, *supra* note 202

<sup>212</sup> SINGER, *supra* note 210.

In addition, Hohfeld presents multi-relationships from one party towards another. <sup>213</sup> In other words, one party can have different jural relationships vis-à-vis different parties that create a variety of correlatives depending on the jural relationship between this party and each of the other parties. For instance, a supplier has a duty vis-à-vis the lessee to comply with the warranties, according to American Law. In addition, the supplier has a duty vis-à-vis the lessor to comply with the contract's conditions regarding performing and presenting the warranties to the lessee. A failure of the supplier creates the right to the lease for damages and the right to the lessor to cancel the contract and recover the price.

Therefore, Hohfeld rightly argues that general terms, such as property do in themselves, give the answer for any legal relationships.<sup>214</sup> On the other, it is the underlying policy that changes these jural relationships. If this is correct, then the concepts of formal ownership or economic ownership are nothing but labels that cover the underlying policies.

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<sup>213</sup> WESLEY NEWCOMB HOHFELD, *Some Fundamental Legal Conceptions As Applied In Judicial Reasoning*, 26 Yale L.J. 16 1913- 1914

<sup>214</sup> *Id.*

## **B. Policy Justification Not Logical Deduction**

To exemplify Hohfeld's ideas, one can look at the hypothetical questions raised in chapter one: who is entitled to the tax credits? For Hohfeld, this question is a policy question. The property concept can not be the answer, since this concept does not give one answer to the question. For the formal approach, the lessor is entitled to such tax credits on the basis of the concept of formal ownership. On the other hand, it is the lessee who is entitled to such tax credit based on the so-called economic ownership. Fallacious as it may appear, both concepts of ownership add nothing to right legal thinking. Why should the lessee or the lessor be entitled to such credits? The property concept here does not give any answer as both approaches base their respective approach on such concepts but with different answers. To answer this question requires identifying the underlying policy.

### **1. Formal Approach (relationship between owner and user)**

The formal approach of Egyptian law grants the lessor any right vis-à-vis the supplier regarding the warranties and representations compliance. One policy justification, one can argue, is to create an investment incentive for financial institutions to provide working capital to the Egyptian market. Giving the privilege to add the assets to its balance sheet and to deduct the depreciation, the financial institution will have more incentive to provide working capital to the market through the finance lease. Furthermore, Islamic compliance is another policy consideration for limiting the finance lease to a relationship between title holder and user. Ignoring the formality of the contract and emphasizing the financial aspect make the finance lease more akin to *riba* prohibitions.<sup>215</sup> Therefore, formality under Egyptian law is a policy consideration, rather than a logical deduction from the concept of property.

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<sup>215</sup> MOHAMMAD HASHIM KAMALI, *Shariah Issues of Islamic Leasing: Perspective of The Lessor*, <http://www.financeinislam.com/article/10/1/553>.

## **2. Economic Reality (A Relationship between a financial conduit and an ultimate purchaser)**

To preserve tax integrity and prevent “double dips,”<sup>216</sup> the Economic reality approach emphasizes the financial aspect in finance lease. Consequently, such an approach creates the so-called economic ownership to give the privilege of tax credits to one party instead of giving both parties tax credits. In other words, unlike the formal approach that gives the privilege to lessor to deduct depreciation and the lessee to deduct the rentals which is considered a double dip, the economic reality limits credit to only one party.<sup>217</sup> To determine this party, the American legal system employs the economic reality test. The party that bears the risks and benefits from the function of the leased assets is the one who is entitled to the tax credits.<sup>218</sup>

### **C. Jural Relationship under Finance Lease**

As previously stated, for Hohfeld, any "problem seems easily to be solved"<sup>219</sup> if it is reduced to the lowest terms of correlatives. Likewise, finance lease distinction can be easy if it is reduced to the lowest terms apart from those artificial terms that cloud, rather than clarify the correct understanding. Applying Hohfeld's system to finance lease, one has to search for the jural relationships finance lease creates in order to reach the intrinsic terms of the transaction to remove the overlap between the finance lease and any other contract. Therefore, two main jural relationships distinguish the finance lease from any other contract: firstly, it is the relationship between the lessee and the lessor, and secondly, the relationship between the lessor and lessee.

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<sup>216</sup> Park, *supra* note 2.

<sup>217</sup> Park, *supra* note 2.

<sup>218</sup> Park, *supra* note 2.

<sup>219</sup> Hohfeld, *supra* note 202

## **1. Lessee v. the supplier**

### **a) Egyptian approach**

According to Egyptian Law, the lessee does not have, by a rule of law, any direct claim towards the supplier as the law applies the theory of formal ownership and allocates all rights to the legal owner. This has led to construing the leasing contract as a mere tenancy contract. However, this perspective of Egyptian law has proven to be fallacious as it ignores the economic reality of the transaction.

In order to reach a correct understanding of the transaction within the Hohfeldian analytical system, one can reduce the transaction to its lowest terms. In this regard, the lessee does not have any right vis-à-vis the supplier.

### **b) American Approach**

As opposed to the Egyptian approach to, Article 2A creates a direct right to the lessee vis-à-vis a duty of the supplier to comply with the warranties. According to this article, this right is limited to claiming the warranties and representation, and thus the lessee has no right to claim the cancellation of the supply contract or to claim the recovery of the price. Obvious as it seems, the application of the so called economic ownership is just a label under which it creates a right of the lessee vis-à-vis the supplier.

## **2. Lessor v. Lessee**

### **a) The Retention of The Title and Security Interest**

As demonstrated above, U.S courts sometimes construe the retention of the title in finance lease as a security interest. Fallacious as it may seem, one can reduce the jural relationship between the lessor and lessee regarding this element. According to the terms of the contract, the lessor retains the title and the lessee has the right of use. In legal terms, the lessor has a “privilege” of the title vis-à-vis a “no-right” of the lessee. In addition, the lessor has a right and privilege vis-à-vis other parties regarding the title. Therefore, the lessor can create another correlative over the title, such as giving some

rights to pledge. When the lessor transfers the use to the lessee, the lessor creates a right and privilege to the lessee to use the goods. In consideration of the financial element, the finance lease creates for the lessor a right and privilege vis-à-vis the lessee. However, upon default of the lessee the lessor has the power to divest the goods. On the other hand, the security interest creates no right to the secured party except in the default of the securing party. It just creates a power to the secured party to change the legal relation by creating a right to divest the secured asset. According to Hohfeld, a power is a "change in a given legal relationship that may result [...] from some superadded fact or group of facts which are under volitional control of one or more human beings."<sup>220</sup> As Hohfeld ascertains, it is obvious that reducing both transactions into their lowest terms results in discrimination as each one of them creates different jural relationship.

#### **b) The payment of the rental (finance lease v. loan)**

Some courts in the U.S. construe finance lease as a loan in the application of the Hell and High water clause.<sup>221</sup> For them, the relationship between the lessor and the lessee "is akin to or exactly-like the relationship between the creditor and debtor."<sup>222</sup> Fallacious as it seems, one has to reduce both relations to the lowest term to remove the overlap between both. The lender transfers a power to the borrower whereby the latter can change the relationship vis-à-vis a liability of the lender to not revoke this power during a period of time. Through the power, the borrower can change the relationship and divest the title of money and use it, and simultaneously the borrower creates a duty vis-à-vis a right of the lender to repay a similar amount with the interest within a certain amount of time.

In finance lease, the contract creates mutual right-duty relationships. The lessor has a duty vis-à-vis the lessee who has the right to use the goods. Simultaneously, the lessor has a right vis-à-vis the lessee who in turn has a duty to pay the rental in due time.

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<sup>220</sup> Hohfeld, *supra* note 202 at 48.

<sup>221</sup> De Lage Landen Financial Services, Inc. v. Rozentsvit, 939 A. 2d 921.

<sup>222</sup> De Rocha v. Macomber, 330 Mass. 611, 116 N. E. 2d 139.

In addition, as the lessor does not select or manufacture or participate in the marketing, these negative operative facts create immunity for the lessor vis-à-vis the lessee's disability to cease the payment for any disputes with third parties.

**c) Economic Ownership (finance lease and conditional sale)**

Based on the so called economic reality, some courts in the U.S. construe the finance lease as a conditional sale and give the lessee the so-called economic ownership.<sup>223</sup> One reason for this argument is the incorporation of a purchase option with a nominal price.

Again, in order to remove this fallacious overlap between those transactions, one has to reduce both transactions to their lowest terms.

Conditional sale gradually creates the power of the purchase upon the payment of full installment, vis-à-vis the seller to divest the title. Also the rule of law creates a privilege to the purchaser to enjoy the tax credits of the depreciation of the assets.

On the other hand, in finance lease, the lessee will have this power only if the lessee uses the purchase option and pays the price, and thus the payment of the rental in itself does not such power. Only when the lessee declares the desire to purchase the goods and pay the price the power to the lessee to divest the title is created.

Tax treatment, thus, is a separate relationship. The law can change the relationship between the parties and create a privilege to the lessee vis-à-vis no-right to the lessor to the tax credit of the depreciation of the asset. :

The renowned Professor Hohfeld provides a legal analytical system based on eight fundamental concepts. Through this analytical system, one can address the fallacy in both approaches of finance lease. Economic or formal ownership are just operative

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<sup>223</sup> De Rocha v. Macomber, 330 Mass. 611, 116 N. E. 2d 139.

facts through which the jural relationships are created. These labels themselves do not provide a correct understanding of the different transactions. On the contrary, they result in confusion and overlap between the different transactions. In this regard, one can use the Hohfeldian system to distinguish between finance lease and different kinds of contracts. This distinction is of practical importance as the finance lease is one of the most important financial instruments in recent time. Therefore, abolishing the finance lease and allocating it under different labels is a fallacy that raises risks or unpredictability and uncertainty of the law. Likewise, ignoring the economic factor of finance lease and treating it as a mere property contract is another fallacy that confuses finance lease with different transactions. It also confuses the relationship between finance lease and the other transactions.

Through attacking the labels, Hohfeld does two things to help understand the modern economic transaction. The first thing, one can argue, is in identifying the underlying policy to understand the different options for constructing architect the modern legal system. The second thing Hohfeld does is to analyze the jural relationships within these underlying policies.

Based on this analytical system, one can understand this economic transaction called finance lease. First, one has to understand the underlying policy to know the options and then to analyze the jural relationships that are created within the underlying policy.

## **V. Conclusion**

In the recent reform of the Egyptian regulatory system of finance lease, one can appreciate the importance of the realization of the economic and financial factors of finance lease. Throughout this thesis, one has tried to address the fallacy of treating finance lease as a mere legal form or a mere economic form. Both add nothing to correct legal thinking. In addition, this addresses a critique of both approaches as they raise the risks that affect the business of the finance lease. Hence, it is not recommended to change the Egyptian law on the basis of the economic reality. Economic reality does not provide the right understanding of the legal relationships of the finance lease. At the same time, it is recommended to realize the jural relationships which finance lease creates within the underlying policies. In other words, any change of the law will affect the jural relationship of finance lease. Therefore, the lawmaker has to look for two things: Firstly, the lawmaker has to identify the underlying policy which the lawmaker wants to protect under the finance lease law. In other words, the lawmaker has to answer the question of whether finance lease is an alternative instrument of finance to both parties whereby one party provides working capital to the other party to facilitate its business. One can argue that the Egyptian law maker has already answered this question by putting finance lease as one of the alternative finance instruments mentioned in law no 10 of 2009 on the establishment of the Egyptian Financial Supervisory Authority. Secondly, based on this assumption, the finance lease law has to identify the underlying policies that govern the relationships between the parties of the transactions. In other words, the lawmaker has to answer the question as to what kinds of rights and liabilities should be allocated to the lessor or the lessee. Thirdly, the lawmaker does not need to identify the owner of the property. Instead, the law has to accurately construct the jural relationship based on the underlying policies. Therefore, the question before the court will be what kind of relationship is created through this transaction.